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# MONETARY POLICY AGAIN

## EDITORIAL NOTE

*The April–May issue of the* BULLETIN *was devoted to a ' Symposium ' on the new monetary policy. In the first two articles Mr. H. G. Johnson and Mr. C. M. Kennedy analysed the technical and economic aspects of the recent changes in monetary policy. These articles were submitted to a number of distinguished economists, who contributed notes, taking up points already raised by Messrs. Johnson and Kennedy and bringing in new points and arguments. In this issue we publish a second, and final, series of comments, which for convenience are numbered to follow the original series. In the first of these new comments Mr. Robert V. Roosa writes from the standpoint of recent American experience. Mr. Frost has practical experience of industrial finance in this country. Professor Hicks puts forward an interesting suggestion of a tax on bank advances, with a view to making use of the monetary mechanism without loading the Exchequer with heavy burdens. Professor Morgan takes up various matters in Mr. Johnson's paper, in particular the question of the 30 per cent liquidity ratio. Professor Kahn returns to the crucial question of the effects of monetary policy on industrial investment. Mrs. Joan Robinson contributes a note on the ' orthodox theory ' of monetary policy.*

*Dr. Nevin's paper is a substantial piece of research, which was submitted to the* BULLETIN *for publication. It is highly relevant to the discussion in the Symposium and despite the fact that it is a good deal longer than the space which had been allotted to the writers of ' Comments ' it seemed appropriate to include it here. Finally Mr. Johnson, who has been given an opportunity to see all the new comments in this issue, contributes a reply to the discussion.*

*THE EDITOR.*

## COMMENTS

### VII

*By* ROBERT V. ROOSA

The papers prepared by Messrs. Johnson and Kennedy, and the supplementary notes contributed by Messrs. Kahn and Balogh, in particular, leave the case for general control over the availability of money and credit very bleak indeed. Although I can scarcely presume to intrude in an analysis of British experience, it does seem to me that developments in the theory and practice of central banking in the United States over recent years suggest some grounds on which the broader generalizations of these writers can be questioned.

There are three stages in the analysis of the new monetary policy : the methods which the authorities can use to control the volume of money and the general availability of credit; the effects which such restraint may be expected to achieve in checking domestic inflation; and the help that such monetary measures may provide toward improving the balance-of-payments position. The writers mentioned have been led to different conclusions from those I would draw at the second and third of these stages largely, I think, because of some fundamental divergencies between their approach and my own at the first stage. For that reason, and because I do not want to exceed unduly the space allotment which Mr. Worswick has had to set for these contributions, most of my remarks relate to that first stage.

## I

The conditions we are discussing are those of an inflationary, or potentially inflationary, situation. In any country served by a fractional reserve banking system, this means that banks have no difficulty in becoming ' loaned up '. So long as there is a fixed ratio between primary reserves and deposits, established either by law or by powerful custom, the money supply and the volume of bank credit may be expected to expand so long as the primary reserve base is allowed to increase. It should follow that an effective limit can be placed upon the total money supply and total bank credit by limiting the volume of the banks' primary reserves. But the writers who are skeptical over the prospects for the new monetary policy have paid no notice to this potential importance of primary reserves because they have set up for themselves what seems to me to be a straw man—that only bank advances, and not the volume of bank credit, are (or should be ?) the object of concern.

Once a limit has been placed on total reserves, or the total money supply, or the total of bank credit, there is certainly a need for optimal allocation of the available bank credit among competing alternatives. However, Mr. Johnson and those who share his views make no provision for fixing these totals and instead push straight on to the advocacy of direct controls over the composition of bank loans and investments to guide the allocation of bank resources among users. My own view is that direct controls, if they are to be used at all, must be confined to the allocating function, but that even in that role they cannot be successful unless they are reinforced by independent measures of control over the total volume of bank credit. It is thus essential, as I see it, for the authorities to rely in any circumstances upon an effective control over the volume of primary reserves that is available to the banking system.

Both in the U.K. and the U.S., it is commonly understood that the central bank is the principal provider of such reserves. It is not so generally recognized, however, that the provision of these reserves results from interaction among the policies pursued by the authorities and the practices not only of the commercial banks but also of the entire nonbank investor sector of the economy. It is too often assumed that credit control takes place only on a one way street running from the authorities to the banks. That cannot be the case so long as all three—the authorities, the banks, and the nonbanks—buy and sell substantial amounts of Government securities, and the nonbanks retain freedom of choice as to whether they will hold Government securities or something else.

To be specific, whenever the central bank attempts to support some predetermined level of Government securities prices, in an atmosphere of expanding or excessive aggregate credit demand, every nonbank sale that results in a support purchase by the central bank will provide an equal amount of additional primary reserves to the commercial banks—even if some device of direct control has already locked the commercial banks solidly into their own holdings of Government securities. What this means is that the central bank can never limit the volume of primary reserves flowing into the commercial banks, so long as it makes support purchases of Government securities in the market. In turn, so long as there is no effective limit upon the primary reserves of the commercial banks, they have the capacity to continue a multiple expansion of the credit and money supply. And the temptation to expand that is created by such ' unused ' reserve capacity would not necessarily be choked off even by transferring all lending decisions to a government office. That office might soon find, as a comparable office did in a neighboring country, that its many individual credit approvals were adding up to an inflationary total—until some firm limit was placed upon available reserves. It would not be enough to place a ceiling on the total loans that the banks (or this vast government office) could grant, because as long as the central bank continued support purchases of Government securities, there would still be a steady one-for-one increase in central bank credit and in the money supply (although not in bank earning assets) with every support purchase of a Government security. Moreover, the volume of sales of securities to the central bank would then be considerably greater as other financial institutions, equipped to extend credits comparable to some part of the customary banking accommodation, moved in to satisfy those borrowers being turned away by the banks.

It thus seems to me inevitable that any attempt to impose arbitrarily high prices of Government securities (low interest rates) on the market will produce continuous increases in the money supply and in the over-all availability of credit, even though the commercial banks themselves have been bound hand and foot. Central banks cannot simultaneously provide artificial support for Government security prices and prevent a growth of the money supply. The reserves provided by central bank purchases lead at the very least to an *equal* growth in the money supply and in the loans or investments of the nonbanks; at the most, to a full multiple expansion of bank loans or investments and the money supply.

There are a number of specific applications of this generalization which contradict positions taken by the critics of the new monetary policy. One of these contradicted propositions is the familiar statement that moderate increases in interest yields have very little influence in halting a credit expansion. The fact is that they may or may not; but the answer cannot be found merely by following Mr. Balogh's search for a rate that will exert a punitive impact upon borrowers' costs. Instead, the principal influence will be found in the effect upon lenders' decisions—not just the banks, but the complex of all lenders. What is necessary is that the central bank be free to back away as far as is necessary to avoid further releases of central bank credit. If the result is only moderate increases in interest yields, then such moderate increases will have been adequate to the job of controlling bank reserves. The central bank has been ' backing away ' in the U.S. for some time now, and the resulting increases in interest rates on short- and long-term Government securities have not been very great. I would not deny, however, that in other circumstances the rise might have had to be greater before yields on Government securities found an equilibrium between the bank and the nonbank buyers and sellers. Once such an equilibrium was found, however, the over-all availability of credit was limited ; there was no longer an inexhaustible fountain of new central bank credit and new money spraying over the economy.

Moreover, it is quite incorrect to attribute the measure of success we have enjoyed in the U.S. to the accidents of bank accounting practices concerning capital losses, as Mr. Balogh has done. The principal source of bank reserves over much of the period of Federal System support was not sales of Government securities by the banks; the banks got reserves mainly because sales were being made by nonbanks in a market in which the maintenance of support prices caused the System to be the principal buyer. When the Reserve System withdrew, it was not with any precise calculation that a rise of 1/16 or 1/4 of 1 per cent, or 1 per cent or 2 per cent, was a desirable end in itself, or that any particular indicated capital loss would be enough to deter sales. The banks and the nonbanks were simply allowed to find a market equilibrium among themselves, on the basis of their own considerations of implied capital losses in the event of sale and of the attractiveness of higher yields. What was important was that market rates were free to move, and that the central bank was free to withdraw from the market (or if necessary to shift over to a net selling position in order to absorb reserves on balance) with interest rates going wherever they might have to go. In the event, the guess that rates would not go very far was justified. But that is far different from saying that the System deliberately moved to a new and predetermined pattern of rates, and that this particular pattern of rates was regarded as endowed with some special properties that were certain to produce the desired degree of credit restraint. The greatest impact of the restraint could not actually be read in the market quotations of prices and yields; but rather it arose from the fact that lenders who wanted to add to their loanable funds by selling Government securities could not tell how much further prices might fall (rates rise) if they unloaded upon the market. This is the kind of ' uncertainty ' that has been of key importance in U.S. credit control; it put a limit on the total availability of funds and forced lenders to ration the credit they had among various borrowers (whether the borrowers might have been willing to pay higher rates or not).

Another misconception is that the Federal Reserve System thought that the necessity for action of the type recently undertaken could have been removed by the imposition of secondary reserve requirements aimed at freezing in some part of the banks' holdings of short-term Government securities. Suggestions along that line were offered for consideration by the Board of Governors some years ago, but they were never generally endorsed by the System. While there are many reasons for rejecting the secondary reserve approach, the fundamental and sufficient reason was that the Federal Reserve System could not, even if all of the diverse holdings of Government securities by the 14 thousand individual banks were somehow securely locked in place, have maintained effective control over the aggregate volume of bank credit or the money supply. Nonbank investors still had large blocks of Government securities to sell, and so long as support was continued at arbitrarily high prices, bank reserves would have continued to grow, with or without a secondary reserve requirement. The essential point is that secondary reserve requirements can never be a substitute for controlling the release of central bank credit; they do not solve the main problem; but they may serve other purposes, such as holding down the debt service charge, since Government securities that are lodged in the banks by compulsion would not have to bear a competitive market yield.

This is not meant to imply criticism of the recent reliance by the British authorities upon the traditional 30 per cent liquidity ratio. Central bankers would be ungrateful indeed if they did not take advantage of customary or institutional practices, where use of them can simplify or aid the fulfilment of the broad objective—general restraint upon bank credit. It is to suggest, however, that reliance upon bank adherence to a 30 per cent liquidity ratio would be an empty gesture, instead of a buttressing aid to effective central bank action, if the central bank did not at the same time follow a course of action calculated to limit the aggregate volume of primary reserves available to the commercial banking system.

That is where, I should imagine, the effect of the rise in the Bank of England's discount rate comes in. Perhaps the influence of a rise in the rate as a signal to the financial community, and the related influence upon lender and borrower psychology, is greater in the U.K. than it is in the U.S.; one would gather from Mr. Johnson and some of the others that this is the only kind of power they are willing to attribute to the discount rate. Without denying that a similar important influence is also exerted by the discount rate in the U.S., our recent experience suggests that the rate itself and the discount mechanism have acquired renewed significance as a control over the volume and availability of bank reserves. The System's withdrawal from support of the Government security market, and the subsequent rise in other short-term market rates of interest, have resulted in ' making the discount rate effective '. Banks have been forced to turn to borrowing, as their primary reserve needs fluctuated in response to temporary and seasonal factors. But bank reserves supplied in this way represent a privilege, not a right; discounts may be refused; and when granted, they have a string attached to them. Sooner or later they must be repaid, and if the System is not supplying reserves to the market through the purchase of Government securities, and if the ' operating factors ' (such as gold inflows) increasing bank reserves are minimal or are offset by other System action, the banks can only obtain reserves for the repayment of their borrowing by letting some credits run off, or by selling Government or other securities to nonbank investors. Moreover, it is an arithmetic necessity, in a fractional reserve banking system such as ours where the required reserve ratios average out at 20 per cent, that the banks must run off (or sell) net four dollars of loans and investments for every dollar of reserves freed for the repayment of borrowings at the central bank. Consequently, the very existence of a substantial volume of discounting becomes in time a powerful cause of bank credit restriction. It is in this way, rather than through the solitary fact of an increase in the discount rate itself, that the discount mechanism has been restored to first rank importance in the methodology of U.S. central banking. Perhaps there is no parallel for this pattern of influence in the British situation; but I cannot escape the thought that something similar may be a potentiality, if it is not already taking place, in Britain.

## II

There was a time when proponents of direct controls argued that physical rationing and price controls made concern over growth of the money supply (and of the availability of credit) largely irrelevant. Now that there has been time for more experience with the elusive and distorting effects of the suppressed inflation that builds up behind a barricade of direct controls when the money supply is unrestricted, there has been a decided shift in thinking. Certainly, with the possible exception of Mr. Kahn, I detect no evidence in the contributions to the first symposium of the old feeling that the money supply does not matter. Instead, there is at least implicit agreement that the money supply should not be allowed to get out of hand. And we find those who might previously have argued that physical controls could ' go it alone ' now arguing that monetary and credit controls are essential, but that these controls, too, should take the form of ' discriminating administrative regulation ' over the many individual situations that comprise the total activity.

If it is agreed, then, that an over-all limit on the money supply and the availability of bank credit serves a necessary purpose (without, of course, going back to the mechanistic and deceptive simplicity of the quantity theory), there is already a broad if unrecognized common ground between the critics of the new monetary policy and those who have been putting it into effect. The issue remaining is whether the greatest usefulness of monetary policy can be realized with control limited to general measures determining the volume of bank reserves (and thereby of bank credit and the money supply) while the allocation of given totals is left to the credit-granting processes of the commercial banks, or whether the whole job should be done by developing a new panoply of direct controls for the commercial banking sector of the economy.

Perhaps the greatest difficulty with the direct controls approach is that it never stops growing. Just as price controls and rationing in the end proved themselves inadequate, leading Mr. Johnson among others to believe that the solution must now be found in creating another set of direct controls for commercial banking, I venture to suggest it is equally certain that once Mr. Johnson got his controls he would find that they had to be fastened tighter and tighter around the banks, and that in the end they would have to be extended to insurance companies, savings institutions, and so on. At any rate, this kind of sequence from one control on to another would be necessary unless the central bank were able to develop strong, general controls to buttress, and perhaps render unnecessary, the set of direct controls that Mr. Johnson now has in mind. The paradox is that direct controls over the banks are proposed as a way of making it possible for the central bank (or some other agency of Government) to continue to keep Government securities prices high and interest rates low. Yet it is that attempt to impose an arbitrary judgment of what such prices ought to be, upon a community in which investors still retain freedom of choice as between Government securities and other kinds of debt instruments, which makes it inevitable that Mr. Johnson's direct control over bank portfolios will prove to be less than the panacea he envisages. The next round will find Mr. Johnson or one of his intellectual descendants sharply pointing out the inadequacies of direct control over bank portfolios and urging that another layer of direct controls be imposed somewhere else.

I cannot argue with Mr. Johnson over his contention that credit rationing as carried out by the banks themselves may not always correspond to the equilibrium of a competitive market, or the highest requirements of the national interest. It does disturb me, though, that those whose faith rests largely upon planned effort always assume something very close to perfection in the implementation of any planning that has not yet been tried, while they are unwilling to forgive some shortcomings of a 'price mechanism approach' that is already at work confronting those many virtually irreconcilable claims that we are wont to impose upon our economies. I do have much more faith than Mr. Johnson in the results emerging from the sum of thousands of judgments by credit analysts whose job it is to make loans and investments that will pay off profitably for the lender, both over the short and the long run. But I have no doubt that in times when a great change-over in the composition of a nation's output is taking place, there may be specific sectors toward which the attention of all principal lenders should be particularly directed by the authorities. I would feel, however, that whenever any such direction becomes necessary in the national interest, it should take place within a framework of general restraint on bank reserves and bank credit in which the discount rate and the open market operations of the central bank do most of the work. Moreover, I suspect that the limited time and capacities of the planners upon whom we would find ourselves relying might more nearly achieve a maximum fulfilment of the national interest if their talents could be concentrated upon those particular priority concerns or industries most in need of special aid. At the same time, I would also suspect that a rationing of all the remainder of the credit supply among the thousands of other shopkeepers who do the humdrum work of the economy could much more safely be left in the hands of the men who make a full time career of finding the most profitable uses for loanable funds, and who are not necessarily unmindful of the needs of their communities.

## III

My remarks thus far have rather neglected Mr. Kennedy. I trust they have cast some doubt, however, upon his conclusion that the results achieved by the new monetary policy (or still to be achieved) could be had ' by other methods both less costly and less harmful to the long run interests of the economy.' I find his peculiar twist in the analysis of the psychological effects of the new monetary policy somewhat of a strain on my credulity, particularly when he argues that business retrenchment is likely to occur because tight money and the depressed conditions of the U.K. during the 20's are synonymous in the minds of entrepreneurs. I do not object to his statement that the situation requires ' not so much the cancellation as the postponement of investment plans.' But I would certainly argue that this is precisely the effect that our own version of the new monetary policy in the U.S. has been having (even though that may not be apparent from aggregative data because of the huge volume of defense-related investment that has taken place.)

I cannot offer any direct analogy from our own experience bearing upon the specific matter of central concern in Mr. Kennedy's paper—the transfer of resources from the consumption goods industries to those with the greatest potentialities for expansion in exports. However, we have succeeded over the past 15 months in cutting our financial cloth to match a substantial shift into the production of defense materials, and we have done that mainly through the central bank's use of open market operations and the discount mechanism to limit the over-all availability of credit, while giving some direction to the allocation of total credit through that modest and unobtrusive variety of direct control known as the Voluntary Credit Restraint Program (the Program was ended in May 1952). It may be of some significance that many of those associated with this particular form of credit direction are fully convinced that the general credit controls were an essential pre-requisite for the success of the V.C.R. That is, lenders were ready to participate in a voluntary program for the allocation of credit to key industries when the total amount of credit they had at their disposal was already limited. Faced with the necessity of doing some credit rationing, they welcomed the guidance provided by this program, and were relieved to fall back upon it in explaining to otherwise credit-worthy borrowers that their demands could not be fully satisfied.

Is it possible that there might be some analogy for the British banker who, having been directed to give particular accommodation to certain priority lines, finds (even though he may not fully realize why) that he does not have sufficient resources to satisfy all of the borrowing demands being pressed upon him? It may also be significant—and of some relevance to my remarks above on the way in which direct controls might move from banks to other lenders—that we found it impossible in the U.S. to undertake even our gentle type of direction of credit by framing it for the commercial banks alone. The V.C.R. Program included not only the insurance companies and the savings banks, but the entire investment banking community as well. The central bank action in abandoning support of Government security prices left all of them ' hard up ' for fresh funds to use in making new credits; and so they, like the commercial banks, joined the V.C.R. effort with a genuine desire to co-operate.

My own appraisal of our recent experience in checking further inflationary developments in the U.S., during the phase of our most rapid retooling for defense, is that general credit controls were a necessary, but not a sufficient, condition for the measure of success that has been achieved. The story is by no means over, and I would be the last to suggest that we are not capable of making many mistakes, and perhaps even of nullifying much of what has been accomplished over this past year during the course of the next one. I do believe, however, that monetary policy has already demonstrated that it can make an important contribution, mainly by limiting the growth in bank reserves, the money supply, and the general availability of credit at a time when the aggregate pressure of demand was so great that its fulfillment would inevitably have aggravated the other inflationary developments at work in the economy. Perhaps in the end something similar can be said for the British experiment—not that the new monetary policy single-handedly accomplished the necessary readjustment of resources within the economy, not that the policy was the sole factor in causing prices to level off, but that neither of these results could have been achieved without the new monetary policy.

*Federal Reserve Bank of New York*
*July* 22, 1952

## VIII

### *By* RAYMOND FROST

While admiring Mr. Johnson's article on the new monetary policy in the April-May issue of the BULLETIN, I feel that the clarity of his account imputes to the sequence of monetary events since last November a degree of coherence that it does not in fact possess. I find it hard to believe that the authorities have achieved their aims as efficiently as he implies.

He holds that the policy has successfully achieved its aim of reducing the volume of advances. But this success can hardly be described as more than modest. By May 1952 the volumes of advances had been reduced to the same level at which they stood at the start of the new policy. A more encouraging sign of the policy's effectiveness is that advances fell sharply between April and May and further declines may well be in store.[1] Perhaps the mere slackening in the rate of growth of advances can be accounted a success. But against this there would probably have been a fall in the rate of growth of advances in 1952 compared with 1951 because the principal cause of the rise in advances during 1952 was an enormous increase in wholesale prices. The national income White Paper figure of £1,200 m. for stock appreciation during 1951 indicates the extent of the financial burden placed on industry by rising prices. But this year the curve of wholesale prices has flattened out, and in addition the volume of production has ceased to grow. These two factors could be expected to bring about a reduction in the rate of growth of industry's demand for bank accommodation, irrespective of any monetary restriction.

This is not to suggest that the government's policy has not had a marginal effect on bank advances. The most effective measures have been the direct controls; purely monetary measures have not so far significantly altered the situation. The monetary measures did, it is true, carry the implication that this set of requests, at least, were to be taken seriously. And the banks have taken them seriously. The requests themselves did not differ in substance from those of earlier years except in one very important respect which was referred to by Mr. Johnson. The Chancellor asked the banks ' that notwithstanding the statutory exemption of borrowings made in the ordinary course of business, bank advances should not in general be made for capital expenditure.' This, coupled with the Chancellor's instructions to C.I.C., to be very tough when considering applications involving the raising of long-term capital to fund bank advances which had been raised for capital purposes, closed the very large loop-hole left by the Borrowing Control and Guarantees Act, 1946, in the control of capital investment.

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[1] Since writing these words the end July Clearing Bank's statement has appeared, showing a decline in advances of £75 m. compared with May, and of £131 m. since April. This is largely accounted for by the repayment of the British Electricity Authority's bank borrowings out of the proceeds of an issue in April of £150 m. of electricity stock, the stock being raised specifically for this purpose. By July the Authority had received and paid to its bankers the cash proceeds. It is worth noting that the B.E.A.'s issue was not a success and about £100 m. of the stock was taken up by Government Departments which financedtheir holdings by borrowing on Treasury Bills. Thus, the B.E.A.'s borrowings from the banks have been repaid largely out of the proceeds of additional Treasury borrowings from the banks. A considerable number of genuine funding operations by private enterprises have also taken place.

But the mechanical effect of the purely monetary measures on bank lending has been negligible. What Mr. Johnson so lucidly described is the way the policy could be made to work, and not what has in fact happened.

He considers that the result of the funding operation of November last has been to restrict the banks' liquidity ratios to the point where they can no longer switch out of money market assets into advances, so that if they wish to expand advances, they can only do so at the expense of selling investments at a capital loss.

This would be very well if the banks' liquidity ratios had been cut to the bone. But they have not. They have remained at a level well over 30 per cent largely because the government's short-term borrowings have been heavy. This is not to suggest that the liquidity ratio convention becomes effective at exactly the 30 per cent mark. On the contrary it does not become effective until the proportion of liquid assets has been squeezed below 30 per cent. Since the liquidity ratio is not a rational calculation of banking risk, but a tradition, the evidence of the past is relevant. Following the example of Mr. King in *The Banker*, I propose to refer to the experience of the 1920',s which was the last period during which an orthodox monetary policy was effectively used. Between 1919 and 1930 the proportion of banks' liquid assets varied from month to month between 2 or 3 per cent either side of the 30 per cent mark. But it is important to note that during periods of credit stringency, the proportion was brought to 30 per cent or below and kept there for several months. In order to force the banks to restrict the amount of their illiquid assets, the authorities had to reduce their liquid assets to below 30 per cent. I do not therefore see that a great deal of importance can be attached to the state of the banks' liquidity ratios to-day as a cause of their restricting advances. Since November last liquidity ratios have varied from 31 to 34 per cent—and up to 38 per cent in the case of individual banks—which is nowhere near the point at which, by tradition, they should reduce their investments or advances—and it is, after all, of traditions that we are speaking.

Mr. Johnson considers that ' to the extent that the reduced liquidity achieved by the funding has been successful in deterring the banks from switching from Treasury Bills into advances, the increase in Treasury Bill rate has been an unnecessary additional deterrent '. Much as one may regret the fivefold increase since last November in the cost of borrowing on Treasury Bills, it is hard to see the logic of this statement.

Assuming that liquidity ratios had been cut to the bone—which they have not—pressure upon them can only be maintained by the use of bank rate. Without raising Bank rate it would not be possible to stabilize the volume of deposits, and restrict the free flow of credit from what Professor Sayers has called ' the Bank's open back door.'

I should like now to deal with the question of whether and to what extent the combined use of bank rate, together with pressure on the banks' liquidity ratios, can be expected to reduce the *supply* of bank advances—which is what Mr. Johnson suggests has occurred—as opposed to the demand. It is interesting to note in this connection that in the 1920's periods of high bank rate and narrow liquidity ratios had a surprisingly small effect on the volume of advances.

During only two years did a fall in advances coincide with high bank rate and low liquidity ratios; 1920, when advances fell between April—when bank rate was put up to 7—and Dec. by £47 m. and 1921, when they fell by £74 m. 1922 and 1930 were the only other years in which advances fell, and both were periods of relatively easy credit in which the decline of advances cannot be ascribed to monetary discipline. It is not at all certain, incidentally, that year 1921 provides evidence that monetary policy restricted the volume of advances by restricting their supply, for in 1921 there was a very serious slump proceeding from other than domestic monetary causes. Only in 1920 does it seem reasonable to impute the fall in advances that took place between April and December to the immediate results of monetary policy. But it is hardly necessary to point out that the 7 per cent bank rate of 1920, coupled with a Treasury Bill rate of 6½ per cent, and with liquidity ratios of below 27 per cent was a very different kettle of fish from our present arrangement of a 4 per cent rate, Treasury Bill rate of £2 9s. per cent and liquidity ratios of well over 30 per cent. The reason for the failure of credit restriction to have an immediate effect on the supply of advances is surely that if they are given the choice the banks will always sell investments before they willingly and deliberately cut down their advances. There is surely good reason to believe that the purely monetary measures of the government's policy have had no effect in reducing the *supply* of advances. But have they restricted the demand ? Mr. Kennedy and Dr. Balogh concluded from the results of the Oxford Economists' enquiry of 1938 that businessmen do not take much account of changes in the cost of borrowing. As Henry Gibbs said : ' bring me the man who has been ruined by a loss of £200 on a transaction of £50,000.'[1] The deterrent effect of high rates on bank advances is also offset by the fact that the borrower is not entering into a permanent commitment to pay more for his money. He knows that a crisis level of bank rate will not be maintained for ever, and that when it comes down, the rate on his overdraft will fall with it. It therefore seems reasonable to suppose that a monetary restriction affects the level of advances only if, by indirect ways, it can bring about a decline in the level of business activity. A recession reduces the number of businesses which, in the banks' view, are sound borrowers, while at the same time these sound borrowers will need less working capital. And the number of sound borrowers declines, partly

[1] Quoted by R. G. Hawtrey in 'A Century of Bank Rate.'

because business becomes less profitable, and partly because the banks raise their standards of what constitutees soundness. I do not need to go into the process whereby pressure on the banking system raises long-term rates both for psychological reasons, and also because the banks sell investments, and to the way this in turn raises rates on long-term capital in the new issue market. One snag in this analysis is the proportionately small extent to which long-term rates follow changes in short-term rates. In the past a change in bank rate has rarely affected long-term rates to the extent of more than one-eighth per cent. Between November, 1951, and May, 1952, the yield on Consols rose by only 0.32 per cent, and this can be considered as exceptionally heavy. But it would appear that the rates on new industrial capital issues can change at such periods as the present more than proportionately to the change in the rates on existing government securities. This is particularly the case if, as at the present time, monetary policy has supervened on declining business prospects. It is important in this connection to note that the rate on new issues is not expressed solely in terms of the monetary rate per cent. Professor Paish points out the way the banks will decline to do business on which the notional rate of interest corresponding to the risk involved is above the limits to which banking convention permits them to go. It is similarly true of the new issue market that a certain class of long-term borrower simply drops out of the market scale of investment preferences when business prospects decline.

But the long-term investor has at his command a flexible financial apparatus which can be used to express a very wide range of interest rates. This is particularly the case when the borrower deals directly and privately with one or two institutional investors, but even with issues to the general public, extremely flexible financial methods can be used, *e.g.*, the conversion loan stock recently issued by the Distillers Company. The terms on which a loan is made by an institutional investor can be tightened up in ways that amount to an expression of a higher rate of interest than that indicated by the monetary rate per cent. For example, in a period when interest rates are low a given business may be able to raise long-term unsecured loan at 4½ per cent. When rates are high the lender may estimate the risk on an unsecured loan at 10 per cent. But financial convention would not permit a 10 per cent unsecured loan, so the lender may ask instead that his risk shall be reduced to a 6 per cent risk by the borrower offering security for the loan, *i.e.*, 6 per cent plus security is the same rate of interest as 10 per cent without it. The other way of dealing with the situation is to obtain the reward for the risk involved by devices such as, in the sort of case we have quoted, lending at 6 per cent with the right to buy a proportion of the borrower's ordinary shares at a price that will yield a sufficient return to make up 10 per cent or more on the amount of the loan and shares combined. There are many such devices, and while they are less determinate in character than the conventional rate per cent., they are nevertheless methods of expressing the rate of interest.

The other snag to the theory that higher rates reduce long-term investment arises out of the findings of the Oxford Economists' enquiry. The answer to this may be that a man may not consider the cost of borrowing to be very important in relation to his expected profits, but he can still be deterred from entering into a commitment to pay 6 per cent for a 20-year loan if he believes that rates may fall within a year or two, when he will be able to raise his money at 5 per cent. Unlike the overdraft rate, the rate on long-term borrowing does not fall when bank rate falls.

But as Professor Hicks pointed out, in the circumstances of to-day, the effect of raising long-term rates on the volume of investment is largely offset by the fact that the forms of long-term investment which are most sensitive to interest rate changes—housing, and public utilities—are insulated from their effects. Since November last the government has offset the effect of higher interest rates on housing by means of a larger subsidiy; it has lent £60 m. to the British Transport Commission at 1¾ per cent for 12 months; and it has supported £100 m. of the £150 m. British Electricity Authority Issue by departmental underwriting.

Higher interest rates have been allowed to take their full effect only upon investment in private industry. In addition, the government has tightened up the physical controls on investment in this sector. It is now extremely difficult to get a licence to build a factory, or to use steel for constructional pruposes. Furthermore, when an industrialist wishes to finance the installation of plant and equipment with borrowed money, the Capital Issues Committee can prevent the fulfilment of his plans if the government departments on whose advice the Committee acts, do not consider that the particular project is in the national interest at the present time. And now that there is an official ruling against borrowing from the banks for the purpose of financing investment in fixed assets, it is no longer possible to evade the government control on capital issues by using bank borrowings instead.

To sum up: both the money and capital markets are dominated by the State to an extent which makes the monetary discipline ineffective.

In the money market fluctuations in the volume and timing of government expenditure create, whenever the budget is in deficit, an additional need for short-term borrowing which, though small in relation to the volume of government expenditure, is large in relation to the resources of the banking system. If the Authorities keep the volume of credit stable when government demands are increasing, these demands can only be met if the government is willing to pay on Treasury Bills a rate sufficient to attract the banks to switch out of investments or advances into Bills—and given their basic reluctance to switch out of advances, and the fact that they would have to sell investments at a loss, this would imply a very high rate on Treasury Bills indeed. But no government is willing to pay very high rates on a floating debt of between £4,000 and £5,000 m. The current rate on Bills of about 2½ per cent is five times as high as the rate ruling up to October 1951, but it is low when compared with the rates of 4 to 6½ per cent which ruled during credit stringencies in the 1920's, when the amount of the floating debt varied between £600 and £1,100 m. But if the government is reluctant to increase the cost of servicing the floating debt, it must expand the volume of bank deposits to meet its demands. Such an expansion will increase the banking system's liquidity ratios, and consequently reduce the pressure on them to restrict advances or to sell investments. That is why the government's plans to restrict credit have been upset by the heavy budget deficit of the first quarter of the financial year, and why it will never be possible with budgets on their present scale to prevent at least the temporary dislocation of any attempt to maintain a consistently restrictive monetary policy.

Another factor which tends to upset government monetary policy is the scale of changes in our balance of payments. When we are in deficit the government can obtain short-term finance from overseas holders of sterling balances. When we have a surplus on our balance of payments, the government can no longer draw upon this source and must make additional demands on the banking system instead. The scale on which changes take place can amount to a serious dislocation of a restrictive monetary policy.

Finally, in the long-term capital market, government and government-sponsored investment is not allowed to feel the effects of interest rate changes.

Perhaps the most that can be said of the ' monetary discipline ' in present circumstances is that it would help in a secondary but useful way to further the aims of a disinflationary budget.

*London.*

## IX

### *By* J. R. Hicks

This second note has been provoked by Professor Robertson's contribution to the first part of the Symposium.

It is, I suppose, inevitable that a Restoration should produce a re-alignment of forces; different people take it in different ways. I myself, and I think Mr. Johnson and Mr. Kennedy also, are mere *ralliés ;* we are prepared to give the new régime a chance to see what it can do, but we do not want, or expect, to put the clock back to 1640 or 1789. Professor Robertson, however, whom one had thought to be a moderate man, discloses himself in the unexpected guise of an *ultra.* Bank Rate is hallowed with the oil of Rheims, and anathemas are hurled at poor Uzzahs like Mr. Johnson, who with the best of intentions are trying to make the Ark of the Lord ride smoothly upon its chariot.[1] Now it is notoriously useless to argue with an *ultra ;* but behind the mask of this particular *ultra* there are disclosed the familiar features of Professor Robertson. It has never been useless to argue with Professor Robertson; one must therefore retain the hope that he can even now be led to look more kindly upon the faces of those who seek to be his allies.

For the reasons which I set out in my first note, it seems to me altogether natural and proper that the new Monetary Policy should have begun by modelling itself as closely as possible upon the old. It was much easier to do this than to do anything else, and it was much better to begin with something that was known to work, than to start what was in any case a Restoration by plunging into uncharted seas. But, at the point which was now been reached, it does seem wise to reflect that we have the Revolution behind us; we cannot go on exactly as if it had never occurred. It shows no lack of respect for the Ancient Institution, and no lack of appreciation of its virtues, if a reasonable man is prompted to consider ways by which it could be moulded, in the course of time, so as to attain a greater effectiveness in relation to the new problems which it now has to face.

All such consideration must be very tentative; I should not feel inclined to be more than tentative, and I do not think that Mr. Johnson did either. There is however no doubt that one of the things about which we can justifiably be troubled in this connection is the relation of Monetary Policy to the burden of the National Debt. In the old days, when most Debt was funded, short-term rates of interest could be varied a great deal without making any serious difference to the burden of Debt on the Exchequer. Now, however, we have an enormous unfunded, or imperfectly funded, debt ; and though the new Monetary Policy has been introduced at a moment when its effects on the Debt charge are temporarily less serious than they might have been, they are already quite serious. If high short-term rates have to be maintained for a period of years, as may well happen, these effects will become much more serious. It is certainly possible to overstate the danger. As Mr. Kennedy has pointed out, the National Debt as a proportion of the National Income is much lower than it was in 1947; again, quite a lot of what the Government pays out comes back to it in taxes. But these qualifications leave the essence of the problem untouched. It consists, in my view, much more in an indirect consequence of the debt charge than in its direct arithmetical effects. The existence of this budgetary repercussion greatly affects the power possessed by the monetary authorities under existing institutions.

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[1] 'And when they came to Nachon's threshing-floor, Uzzah put forth his hand to the Ark of God, and took hold of it ; for the oxen shook it.

And the anger of the Lord was kindled against Uzzah ; and God smote him there for his error ; and there he died by the Ark of God.

And David was displeased, because the Lord had made a breach upon Uzzah ; and he called the name of the place Perez-Uzzah to this day.' (II Samuel vi 6).

As I explained in my previous note, I cannot see that the traditional effectiveness of Bank Rate implies that the actual rate fixed at the moment had any decisive importance in the exercise of monetary control; no one has ever been able to explain why a rise in short money rates from (say) 3 to 4 per cent should in itself have been able to have a tremendous effect on the profitability of business. But it was always understood, in a crisis, that Bank Rate could be raised, and go on being raised, until it did exercise a sufficient effect. The possession of this reserve power was the real strength of the Bank; as people became accustomed to the knowledge that the reserve power existed, it rarely required to be exercised. Quite a small rise in Bank Rate was taken as a signal; and a signal was enough.

As things are at present, the reserve power does not exist, and one of the main reasons for its absence is the effect on the debt charge. Bank rate policy is now, for good or ill, a part of Government policy, and Government policy is bound to have a financial bias in favour of Cheap Money. (That Government should have an economic bias in favour of cheap money may be a very good thing; but its financial bias will push it beyond the point which is economically desirable). Though this danger may not at the moment appear to be very pressing, it is one which is bound to be present under existing institutions. The Treasury is bound to resist rises in Bank Rate which will aggravate its budgetary problems; Parliament is bound to resist the handing out of taxpayers' money to financiers and rentiers. The Bank cannot be expected, in the long run, to have a free hand.

If this conclusion is accepted, and I do not myself see how it is to be avoided, the basic problem of British monetary policy, at least in the longer run, is to find a monetary weapon that can be *freely* used. Such freedom cannot now be secured by the use of the old-fashioned monetary instruments, but it is not obvious that it is impossible to secure it in some other way. Economists, surely, are not wasting their time if they look about for alternatives.

This, it seems to me, is what Mr. Johnson was doing. He presented us with two alternatives, and I have no others to add. I should, however, like to add a page or two on the alternatives which he mentioned.

One was the minimum reserve ratio. Banks might be compelled to hold either cash, or a particular sort of short-term government debt (bearing a conventional low rate of interest) against a certain proportion of their deposits. The proportion could be varied from time to time, as is done with reserve ratios in the United States. In British conditions, a scheme of this sort could possibly be introduced by arrangement with the Banks, though the recent history of T.D.R.'s is not encouraging in this connection. It would be better and fairer to make it a matter of legislation. There are plenty of precendents for this sort of thing in the relations of the Government with the Bank of England, and the Banking system as a whole now occupies a position in the British economy rather analogous to that occupied by the Bank of England a hundred years ago. It is not unreasonable that the Banks, occupying the position that they do, should pay something for their privileges.

My own difficulty with this proposal is a doubt whether it goes far enough. It would be equivalent to a cheap method of funding a part of the floating debt, but no more than a part of the Debt could be funded in this way. The budgetary effect of high interest rates would be damped down by a measure of this kind, but it would not be removed, and might not be sufficiently diminished. One cannot therefore be sure that this is the best solution.

The other alternative was the tax on advances. I do not think that this will do in the simple form which first suggests itself, but it is a proposal of greater theoretical interest, and it may be capable of elaboration into something practical. At least it is worth looking into.

Let us allow ourselves, for the moment, to think of the Treasury (including Exchange Fund) and the Banks (including Bank of England) as forming a single Complex; then what we require is a method whereby the lending of the Complex should be restricted, while lending to the Complex should be left as far as possible undisturbed. When we look at the matter in this way, it becomes apparent that it is not *necessary* for the rates of interest at which the Complex lends, and those at which it borrows, to have a close relation to one another. What is needed is to find a practical way of breaking this relation, so that the lending rate can be raised without the borrowing rate being raised. Once the relation was broken, there would be nothing, in the way of financial considerations, to stop the lending rate being raised as high as one liked. Therefore, once the relation was broken, the old power of the rate of interest to act as a signal would be restored. And, in accordance with what has been said above, if it was known to be restored, there would rarely be any need to use it at all violently.

The trouble is, of course, that the Treasury and the Banks do not in fact form a unified Complex; relations between the Treasury and the Banks have also to be considered. Nevertheless, as soon as we conceive the problem in terms of the separation of one rate of interest (or set of rates of interest) from another, the mind naturally moves in the direction of the time-honoured device for separating one set of related prices from another, namely the imposition of a tax on the passage from one market to the other. There is a close analogy with the case of a protective tariff. If it is desired, for whatever reason, to weaken the connection between certain domestic prices and the corresponding foreign prices, a straight-forward protective tariff, variable on occasion, does the job with less interference with the course of trade than any alternative method. So it may be here.

Let us suppose, as a first approximation to the device for which we are seeking, that the Chancellor of the Exchequer is given power to impose, by Order in Council, a tax on bank lending. Lending to the Government itself, whether on Treasury bills or otherwise, should be exempted from the tax; but it would fall, at a uniform rate, on all other forms of bank lending, whether by advances or by discounts of commercial bills. Such a tax would be a very powerful weapon, and it would therefore be essential that it should be removed the moment it had done its work. It would be impossible to put it through the processes of ordinary budgetting, which would make it far too slow in operation. It would have to be completely outside the Budget; the revenue from it would be applied to debt redemption as a matter of principle. Power would have to be taken to vary it, even from week to week, just as Bank Rate used to be varied. Indeed, the more like Bank Rate it could be made, the better.

The effects of a tax of this sort might be expected to be somewhat as follows. I assume that the tax would be paid in the first instance by the banks themselves, as this would be by far the easiest method of collection; the banks would pay (say) 1 per cent per annum, or an equivalent rate *per diem*, on any loans of whatever kind (including investments) which they made to other parties than the Government (or, of course, each other). But though the tax was paid by the Banks in the first place, they would naturally pass it on to their clients, at least in the majority of cases. (There need be no rule about this; no control of bank lending rates would be needed.) Whether or not the tax was passed on, bank lending would be discouraged. If borrowers had to pay higher rates, their borrowing would be discouraged; the banks themselves would be less willing to make advances, in all cases where they had to bear some part of the burden of the tax. But—in contradistinction to what happens when the cash reserves of the banks themselves are attacked—the banks would have no incentive to reduce their investments in Treasury bills or in Government bonds; rather the other way about. The gilt-edged market would be strengthened by bank purchases, not weakened by bank sales—though of course there would be an influence in the other direction from those would-be borrowers, who now preferred to sell government securities, rather than pay the higher rates of interest which the banks were demanding.

So far, the effects of the tax would seem to be as intended; but there are several special difficulties, which make it certain that the plan would not do in precisely this form. Some of these are concerned with the definition of a ‘ bank ’. Take, for instance, the situation of discount houses, which use bank credit largely for the purchase of government debt. It would be advantageous, both for the discount houses themselves, and for the working of the scheme, if they were reckoned as *banks*, so that bank lending to the discount houses would be untaxed, though lending by the discount houses to others than the British government would be taxed. There might have to be several extensions of this type.

This special case does indeed lead on to a wider problem. The ultimate object of the scheme would be the separation of a short-term market in governments, kept within the Complex, from the rest of the capital market, left outside. In so far as outside bodies, such as insurance companies and building societies, held large amounts of short-term governments, they would be able to undercut the banks by making advances financed by the disposal of their short-term government debt. This is a serious difficulty, which it might not be possible to remove at all quickly or easily. But the direction in which a solution might be looked for is fairly clear. What would have to be done is to sort out the financial system into two classes of concerns, Banks and other insiders on the one hand, outsiders on the other. Insiders would have to pay the tax[1] on their loans to outsiders; but they could, on the other hand, be given the right to hold short-term governments, which would be interest-bearing and yet fairly stable in value. Outsiders would be exempt from tax but would not have this privilege. They would be obliged to hold their reserves, either in bank deposits, bearing no interest, or in long-term bonds, subject to market fluctuation. In order to see that a line could be drawn between the two classes which was tolerably convenient, some funding operations would probably be necessary, but they need not be very extensive. Apart from the pressure which would be exercised by such funding, there would be nothing compulsory about the division between the classes. Any concern (apart, perhaps, from the Joint Stock Banks in the narrow sense) could be allowed to choose on which side of the line it would station itself. There would not even be any necessity for it to make an irrevocable decision, since privilege would go with payment. If outsiders desired to come inside, they would become liable to pay the tax; if insiders desired to go outside, they would lose their privilege.

I wonder whether there is any possibility that an idea of this kind might, after all, commend itself to Professor Robertson; certainly it means building fences, but the fence is of a very mild variety. Really, it seems to me, some sort of fence is in the problem; if we are not allowed to build fences, we shall have to wait until the cows come home.

*All Souls College,*
*Oxford.*

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[1] When any tax was imposed ; it is to be supposed that the rate of tax would not infrequently be zero.

## X

### *By* E. Victor Morgan

Messrs. Johnson and Kennedy have started so many hares that I must be very selective in those which I chase, and I propose to confine my attention to a few of Mr. Johnson's. To save space, I shall mention only the points where I differ from him, but the reader will be able to infer how large is the area of agreement between us. Our differences fall into two groups, those concerned with policy recommendations, and those which concern the pictures which we form of how the financial system works.

To take the second point first, Mr. Johnson sees the picture in black and white, each of its parts delineated in clear, hard lines, whereas I see far more grey, more shading of one thing into another. One example occurs at the beginning of the paper, when Mr. Johnson assumes, ' the existence of a substantial inflationary potential demand, which could be financed by bank advances, but not by any other means,' and so identifies the problem of credit control with the control of bank advances. There are many ways of financing spending on currently produced goods and services besides bank advances and new capital issues. Among them are the selling of securities or of fixed assets, the discounting of bills, and the raising of loans from people who have access to money through any of these channels. This, of course, is Mr. Paish's ' osmosis ', and it is a process that works in subtle and devious ways.

Thus, although advances are certainly the most direct way in which the banks might finance ' an inflationary potential demand ', they are by no means the only one. Suppose, for example, that a bank buys the securities which Mr. A. sells in order to buy a house, rather than have recourse to a building society. The society has that much more free resources, and it can now lend to Mr. B. to buy a house from Mr. C. which he could not otherwise have bought. Finally, since we must end this story quickly, suppose that Mr. C. ' blues ' the proceeds in the market for durable consumer goods. Had it not been for the action of the bank Mr. C. could never have increased his current spending except by an equivalent contraction in the current spending of someone else. The bank has thus brought about a net increase in spending just as effectively as if it had given Mr. C. an overdraft.

An increase in any form of bank lending must produce an equivalent increase in current spending either directly or indirectly unless there intervenes, at some stage in the chain, someone who is prepared merely to exchange existing assets for bank deposits. This is the only distinction I can see between advances and, say, investments. While it is certain that a customer will not incur an overdraft except for current spending, it is *possible* that a bank may buy securities from someone who sells purely because he prefers bank deposits to bonds as a means of holding wealth. In that case, of course, the two could accommodate one another without any effect on the outside world. But though this may happen, it is very unlikely that it will happen often in a time when there is a heavy potential demand struggling to obtain finance.

Moreover, bank deposits—even those created by the most innocent exchange of assets—are potential spending power immediately available to their holders. Thus a community with an abnormally high ratio of deposits to national income runs an abnormal risk of sudden jumps in its rate of spending. In an underemployed economy this would not matter, but in one hovering on the edge of inflation it can be an important source of instability. I feel that the modern emphasis on income and expediture flows has sometimes led us to neglect the influence upon these flows that a large stock of liquid assets may exercise.

On both counts, I believe that monetary policy should aim at controlling ' the overall volume of bank credit '. The fact that the new monetary policy does this is one of my strongest reasons for preferring it to a mere restriction of advances, whether by exhortation or directive.

Another point at which my picture is less sharply defined than that of Mr. Johnson, is the ratio of liquid assets to deposits. The thirty-per-cent rule is not nearly so hard and fast as has sometimes been supposed. The annual averages of the monthly statements for the Clearing Banks from 1919 to 1938 are as follows :

*Percentages of Liquid Assets to Deposits*[1]

| *1919* | *1920* | *1921* | *1922* | *1923* | *1924* | *1925* | *1926* | *1927* | *1928* |
|---|---|---|---|---|---|---|---|---|---|
| 40.6 | 31.9 | 37.9 | 37.1 | 35.1 | 32.6 | 32.4 | 31.9 | 32.3 | 33.0 |

| *1929* | *1930* | *1931* | *1932* | *1933* | *1934* | *1935* | *1936* | *1937* | *1938* |
|---|---|---|---|---|---|---|---|---|---|
| 31.6 | 33.2 | 31.9 | 34.1 | 34.1 | 30.6 | 31.2 | 32.2 | 29.9 | 29.5 |

[1] Figures for 1919–24 from Macmillan Report ; for 1924–38 from Bank of England Statistical Summary. There are slight differences between the two series, but they do not seriously affect comparability for this purpose.

Even if we take only the last fifteen pre-war years, there are fluctuations from 29.5 per cent to 34.1 per cent, and there is no obvious pattern in them. Presumably figures at more frequent intervals or for individual banks would reveal still wider variations.

The banker is faced with a perennial conflict between liquidity and profitability, but not with a hard and fast line between liquid and illiquid assets. A very short bond is as liquid as a bill, and some advances are much more liquid than others. I have no more claim than any other academic economist to read the minds of bankers, but surely it is reasonable to suppose that they pay attention to the whole range of assets, and not merely to their division among a few rather arbitrary categories. If this is so, the size of the liquid assets category will depend upon the liquidity of the assets outside that category; if his bonds are mostly very short, a banker may be content to hold less bills, and vice versa. It is likely, too, that the state of inner reserves has some influence ; the penalty of illiquidity is the risk of price fluctuations, and the stronger the inner reserves, the more of this risk a banker might feel justified in taking. Finally, though banks are certainly not speculators in the ordinary sense, they can hardly avoid taking a view of the market, and they cannot be expected to add to their securities when they expect prices to fall.

These considerations are so obvious that I hesitate to set them down, but perhaps they help to explain that ' reluctance of the banks to exchange their bill holdings for higher yielding investments ', which Mr. Johnson finds, ' something of a puzzle '. According to Mr. Kennedy, only about £2,000 m. of government securities mature before the end of 1955 (excluding the new funding stock). These are held by government departments, the money-market, foreign banks and currency boards, and, to some extent by private firms and individuals as well as by the clearing banks. The banks themselves hold about £1,500 m. of investments (excluding the new funding stock), so it is clear that they must hold a considerable amount of, for them, comparatively long-term securities. Any large additions they might make to their investments, in the absence of fresh supplies of short-term bonds, would also have to be in medium- and long-dated issues. Added to this, the fall in securities prices since 1946 must have bitten deeply into inner reserves, and until very recently there has been no reason for feeling anything but bearish about the future of gilt-edged.

These considerations suggest that the liquidity ratio rests on a rational evaluation of the pros and cons of different forms of banking asset, and not merely on the weight of tradition. It also suggests that the thirty per cent rule is bound to be flexible, and in particular, that a revival in confidence in the gilt-edged market coupled with further pressure of costs on earnings might cause bankers to take a different view. In this case there might still be some switching from bills to investments and it might be necessary to have either a further rise in short-term rates or another funding operation.

On the significance of the November funding, I agree with Professor Robertson that it is necessary to distinguish between a ' once and for all cleaning up operation ' and a method of ' continuous control '. Viewed in this light, the operation has a parallel in the nineteen-twenties though then the reduction of Treasury bills was more gradual. The banks ended the First World War with a liquidity ratio of more than 40 per cent. In 1920, they reduced their Treasury bills and increased investments and advances; other holders were also anxious to reduce their bill portfolios, and the Treasury had great difficulty in renewing maturing bills. Bank rate rose to 7 per cent and Treasury bill rate to 6½ per cent and both stayed at this level until well after the breaking of the boom. By 1921, the banks again had a very high liquidity ratio, and it was then that the Treasury began the drastic reduction in the supply of bills, which continued over two years and brought the liquidity ratio down towards the thirty per cent mark. Several authorities, including Sir Basil Blackett and Sir Otto Niemeyer have stated the reasons which inspired the Treasury at that time, and the position is fundamentally the same to-day. In a few words, the significance of the funding operation is that it leaves the Bank of England free—if it so desires—to enforce a contraction in the cash base and in the overall volume of bank credit without bringing about an inordinate rise in short-term rates. I do not doubt that the Treasury, in planning the future structure of the public debt, will bear in mind the supply of liquid assets to the banking system, but I cannot envisage the systematic manipulation of the debt from day to day as an instrument of continuous control.

There are three of Mr. Johnson's policy recommendations on which I should like to comment very briefly. It is, of course, true that the Bank, with the consent of the Treasury, could limit advances by direction under the Bank of England Act, but I do not think such a control would be very effective unless it extended to other forms of bank lending, and to the lending of persons and firms other than bankers. This would involve new legislation, and the arm of the law would have to be very long and to stretch very far into what we used to call our private lives.

The question of a secondary reserve is a very large one, and here I will only suggest that there is a great difference between the Federal Reserve plan (which is part of a policy including the stabilisation of all government bond prices) and Mr. Johnson's scheme for forcing the banks to keep what they regard as an undue proportion of an unremunerative asset.

Finally, a word on Mr. Johnson's contention that there is no good reason to suppose that the rationing of credit by bankers corresponds, ' either to the equilibrium of a competitive market or (more important) to the requirements of the national interest.' I have no doubt that credit control does involve some ' rationing ', though I think one can over-estimate the insensitiveness of advances to a sharp rise in rates. If dealers are uncertain as to the future course of prices a rise in interest charges may induce a change in attitude towards the size of their stocks, and it may also induce people who have been borrowing rather than sell securities to change their policy.

I am very conscious of my ignorance of what is in ' the national interest ', but I think there are reasons why rationing by bankers should conform reasonably well to it. Mr. Paish has pointed out that a tighter rein on the banks by the monetary authority can be a complement to and not a substitute for other forms of Treasury guidance. Moreover, the banker has an interest —in order to maintain the liquidity of his advances and minimise the risk of bad debts—in lending to firms in an expanding market and keeping down advances to firms whose market is likely to contract. If the government decides that rearmament, exports and agriculture are in ' the national interest ', and takes steps to promote these interests and to restrict spending in other directions, the banks will stand to gain by regulating their lending on the same principles. There are bound to be some divergences, particularly in regard to well secured personal overdrafts, but the community of interest is likely to be the dominant factor.

The alternative to rationing by bankers is, of course, a much stricter and more detailed control by the Treasury and the Capital Issues Committee.

Wartime experience suggests that this sort of control works very well when dealing with all-or-nothing decisions and matters of absolute priority, and very clumsily when dealing with marginal adjustments and matters of relative priority.[1] It is certain that we cannot get out of our present difficulties by giving absolute priority to a few forms of economic activity. On the contrary, any tolerable solution must involve an immense number of delicate marginal adjustments. When it comes to adapting credit policy to this sort of change, I am convinced that the banks, under the general control of the central bank, are equipped to do the job far better than it could be done by any other machinery that could be created in the foreseeable future.

*Swansea.*

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[1] See ' Lessons of the British War Economy,' ed. D. N. Chester, especially Mr. Chester's own essay.

## XI

### *By* R. F. Kahn

In his contribution to the earlier *Symposium* Mr. Kennedy threw out a challenge to those of his commentators who believe in traditional monetary policy. He suggested that while ' the expansion in exports must in the first instance be achieved mainly by a cut in investment, . . . the reduction of the level of private investment must not be regarded as anything more than a temporary solution and must be made good as soon as the necessary resources can be transferred from the consumption goods industries.'[1] But on the question of the seriousness of relying on a reduction of industrial investment we received little help from those to whom Mr. Kennedy's challenge was addressed. Professor Robertson and Professor Paish admitted that it *was* serious. They realised that Mr. Kennedy would prefer a policy which ultimately placed the burden of adjustment entirely on consumption and not partly on investment, but they both retreated from consideration of their objective, along a line opened up to them by Mr. Kennedy, who, they claimed —perhaps with justice—was not clear whether he wanted to cut the demand for consumption-goods industries which were already depressed. In so far as the choice between cutting consumption and cutting investment is a choice between the ' Regulatory function of taxation ' and monetary action, Professor Hicks based his decision on the political issue rather than on any discussion of the economic importance of investment. Mr. Harrod is the one who really did try to meet Mr. Kennedy's challenge on ' the crucial issue of investment versus consumption.' His treatment has already been discussed by Mr. Worswick in his ' Conclusion ' and I would add only one further suggestion.

Mr. Harrod argued that investment would, if not curbed, be largely devoted to ' widening ' rather than to ' deepening ' the structure of production. In other words, Mr. Harrod believes that investment decisions have not been correctly directed either to the national interest or to the private interests of those who have made the decisions. But is there any reason to suppose that higher rates of interest would reduce the bias against increasing the ratio of capital to labour. And would not a substantiation of Mr. Harrod's doubts be a serious blow to the case for free enterprise ?

It appears to have been common ground among the contributors to the earlier *Symposium* that, whether regrettably or not, credit restriction operates by curtailing investment. For those—such as business men complaining of of the erosion of industrial capital by heavy taxation—who feel concerned about our industrial efficiency, this raises a serious conflict. But there is at least one authoritative quarter in which an attempt was already being made —about the time when the earlier *Symposium* was published—to reconcile the need for ‘ a substantial increase in industrial investment at home ’ with belief in traditional monetary policy. Such a substantial increase is the third crucial objective of policy discussed in the May number of *The Banker* in an article entitled ‘ Can Monetary Policy carry the Load ? ’ For the assaults on the other two objectives (to overcome the strain on our gold reserves and to divert capital goods from home investment into the export markets) monetary policy has, of course, been entrusted with the major responsibility. But so, according to *The Banker*—and this is what is surprising—has the assault on this third objective of *increasing* industrial investment. *The Banker* suffers from no qualms of economic theory—its only doubt is whether monetary weapons ‘ can be equal to the task ’; whether they will not ‘ need to be wielded more vigorously ’; and whether bankers may not regard ‘ as unfamiliar, even as far-fetched and fanciful ’ the suggestion that ‘ in the assaults upon every one of the three crucial objectives, the bankers are now in the front line ’. ‘ The Government has not . . . added any non-monetary weapons to those employed by the Labour Government,’ and ‘an astonishingly heavy responsibility has been loaded on the shoulders of monetary policy.’

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[1] Bulletin, April and May, 1952, p. 135.

Astonishing indeed, now that dear money has had allotted to it the task of securing a ‘ notable switch of labour into the capital goods industries’. No wonder that *The Banker* has to complain that on the question whether monetary measures ‘ could or should be expected ’ to produce such a switch, ‘ the bankers would give a resounding negative ’. But instead of being guided by the bankers into seeking alternative policies and measures, *The Banker* pleads for courage on the part of the Government in pursuing a tougher policy even though this might be ‘ acutely painful for the banks ’. What is necessary, says *The Banker*, is that credit restraint should be taken to the point at which consumption is curtailed as well as investment, and to the point ‘ at which consumer demand is checked because workers are discharged—in response to monetary pressure rather than to a fall in overseas demand ’ (which the Government appears to regard as quite bad enough). In this way there will be promoted ‘ a flow of labour and other productive resources into these critical industries ’ which provide for export and industrial investment at home. *The Banker* admits some doubt as to the wisdom of relying on monetary pressures alone. But ‘ scarcely any other overt policies are working to achieve ’ the switch. So we must cut investment in order to secure the release of labour required to expand investment. I find it impossible to reproduce *The Banker's* argument except in the form of a *reductio ad absurdum* of traditional monetary policy, which, quite unintentionally, it in fact is.

As, however, Professor Sayers has recently pointed out,[1] ‘ the effects on saving should also be considered. . . It may even be that a high interest policy would make possible actual expansion of investment programmes—an expansion Britain sadly needs’. Professor Sayers has in mind that with higher rates of interest might be coupled 'a "savings drive" aimed at the smaller incomes.'

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[1] ‘ The Development of British Monetary Policy, 1951,’ *Quarterly Review of the Banca Nazionale del Lavoro*, January–March 1952, p. 9.

I had already in my contribution to the earlier *Symposium* suggested that if the Government think clearly about this matter, they must realise that their monetary policy is not the traditional monetary policy but is simply something temporarily forced on them by the shortage of steel. That doctrine is obviously unpalatable to many, and the steel shortage is seldom referred to in these discussions, except by the Chancellor of the Exchequer himself. To my mind the overwhelming question is what the Government will do when more steel could be secured (if necessary by paying dollars for it). If we are then still in balance of payments difficulties will the Government drift into behaving as though it was after all the traditional monetary policy to which they were desperately clinging ?

That is the great danger, entailing a continued discouragement of industrial investment no longer justified by lack of raw material. *The Banker* would maintain that, on the contrary, if carried out sufficiently ruthlessly monetary measures should result in an expansion of industrial investment. I have been labouring this confusion of thought, partly because this article in *The Banker* really does deal with the mechanics of monetary policy and does not simply take refuge, like most published articles on the subject, in sanctimonious claptrap about the virtues of ' monetary discipline ' and ' flexibility of interest rates ', partly because any article in *The Banker* is authoritative and influential (unlike, I fear, the Oxford *Symposium*, which has been subject to what looks almost like a conspiracy of silence on the part of the press).

But I have not been entirely fair to *The Banker*. Attention is concentrated in one section of the article on the effect of monetary measures in forcing a reduction of stocks, and in this limited aspect *The Banker's* argument would be perfectly sound, but for the fact that at the moment (so the Government tell us) there is no steel to employ the displaced labour with and that by the time the steel could be secured stocks of finished goodf would, if *The Banker* had its way, be down to rock-bottom and the labour temporarily released on account of the reduction of stocks would be re-employed in the consumer-goods industries. (*The Banker* recognises that stocks are abnormally heavy just in the case of the industries which are already depressed and that a policy of adding to the unemployment in the textile and clothing industries by forcing them to liquidate their redundant stocks may not commend itself to the Government.)

Here is yet another issue on which more light is badly needed. To what extent does credit restriction operate on stocks rather than on investment in fixed capital (*a*) in fact, (*b*) in the minds of those who advocate it ? And in so far as it does, is it a purely short-term device which ceases to do much good (and may do harm) after stocks have been brought down to minimum levels? Mr. Worswick is of course right that we need much more empirical research.

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## XII

### *By* Joan Robinson

The new monetary policy is acclaimed as a return to orthodoxy. Orthodoxy means the acceptance of ideas not fully understood, and as Professor Kahn has pointed out,[1] there is an extraordinary divergence of opinion amongst the upholders of orthodoxy as to what it is that they uphold. It seems worthwhile, therefore, to return to the fountain head, to examine the theory as it was originally set forth and to imagine how far it remains appropriate in present-day conditions. The *locus classicus* for the theory of bank rate policy is the Cunliffe Report of 1918 (Cmd. 9182). The account it gives of the currency system before 1914 is as follows: 'When the balance of trade was unfavourable and the exchanges were adverse, it became profitable to export gold.' . . . If the outflow of gold was considered dangerous, 'the Bank raised its rate of discount. The raising of the discount rate had the immediate effect of retaining money here which would otherwise have been remitted abroad and of attracting remittances from abroad to take advantage of the higher rate, thus checking the outflow of gold and even reversing the stream.'

So far the argument is based upon empirical experience. Bankers had discovered that the mechanism worked. But this part of the doctrine, which is the best established, is the least appropriate to our present situation. A rise in bank rate attracted remittances when there were no impediments to exchange transactions, and when there was no expectation in anyone's mind of an alteration in the exchange rates. Nowadays, in so far as capital movements are not controlled they are influenced by speculative expectations, and the secure and calm convictions of operators in the decade before 1914 no longer exist. Bank-rate policy will now work in the orthodox way only if financiers and traders believe that it will prevent a devaluation of sterling, and the opposite belief, that a rise in bank rate indicates a coming crisis, is at least as likely to prevail. Thus the modern version of the orthodox doctrine is based on the ground that it will turn out to be correct if everyone believes in it, in spite of any evidence to the contrary.

This part of the argument concerns only the immediate reaction to a rise in bank rate. The Report proceeds: 'If the adverse condition of the exchanges was due not merely to seasonal fluctuations, but to circumstances tending to create a permanently adverse trade balance, it is obvious that the procedure above described would not have been sufficient. It would have resulted in the creation of a volume of short-dated indebtedness to foreign countries which would have been in the end disastrous to our credit and the position of London as the financial centre of the world.' Here there seems to be a certain confusion. The problem is not that a large inflow of remittances would be undesirable (though this was no doubt true) but that a once-and-for-all rise in bank rate could not attract an indefinite stream of remittances. There was only a certain amount of short funds ready to move in response to a given difference between the rates obtainable in London and elsewhere and a continuously *rising* difference would be required to maintain a given flow of remittances over a long period.

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[1] Bulletin, April–May, 1952, p. 150.

But however that may be, the main argument stands. The rise in bank rate must produce further consequences if it is to have more than a purely temporary effect : ' But the raising of the Bank's discount rate and the steps taken to make it effective in the market necessarily led to a general rise of interest rates and a restriction of credit. New enterprises were therefore postponed and the demand for constructional materials and other capital goods was lessened. The consequent slackening of employment also diminished the demand for consumable goods, while holders of stocks of commodities carried largely with borrowed money, being confronted with an increase in interest charges, if not with actual difficulty in renewing loans, and with the prospect of falling prices, tended to press their goods on a weak market. The result was a decline in general prices in the home market which, by checking imports and stimulating exports, corrected the adverse trade balance which was the primary cause of the difficulty.'

This argument has not the same empirical backing as the description of the first phase of the operation of bank-rate policy. It is the interpretation put by economists upon events rather than the emanation of the experience of generations of bankers. Moreover it is not altogether clear. Three phases of reaction seem to be boiled into one. First there is the shock effect of a rise in the cost of borrowing upon the holding of stocks. Unloading of stocks causes a temporarily fall in prices (and check to demand for imports) which may give a temporary relief to the balance of payments, but clearly cannot restore a continuing equilibrium.

The second phase follows when investment plans are revised downwards. The Cunliffe Committee rely on a combination of a rise in the long-term rate of interest (induced by the rise in bank rate) and a restriction of credit to curtail investment. Since their day the effect of interest rates on investment has been much debated, and nowadays it is usually argued that a rise in interest in itself has little effect; the main emphasis is on the availability of credit.

Once this is conceded, the claim that bank-rate policy is a delicate impersonal instrument which frees us from reliance on ' commissars ' who take a view about national investment requirements reduces to the claim that the judgment of bankers is the best guide to what schemes of investment should be encouraged and what curtailed. But since the bankers themselves receive instructions from the Government the whole distinction between orthodox monetary policy and unorthodox interventionism wears very thin.

Whether the mechanism is conceived to work mainly because a rise in interest rates reduces the desire to invest, or because a reduction in the supply of finance reduces ability to invest, the rest of the argument follows : There is unemployment in constructional industries and what we have since learned to call the multiplier reduces employment in consumption-good industries also. Thus there is a reduction in national income, a consequent fall in import demands, and a decline in prices (which may be favourable to exports) in so far as conditions of supply are less than perfectly elastic. In this phase, the continued equilibrium requires continued unemployment. The Cunliffe Committee was quite clear (though their language is euphemistic) that bank-rate policy can work only by creating unemployment and they fail to show any reason to expect the correction to the balance of trade to be maintained unless unemployment continues. Their remedy for unbalance is the fall in prices which accompanies a fall in investment, and it follows that, if employment were restored to its former level, the deficit in the balance of trade would reappear.

It is necessary, therefore, to carry the argument through to a third phase, when unemployment has driven down money wage rates (in the home country relatively to the world level) so as to increase the balance of trade at any given level of employment sufficiently to allow employment to recover. When wages have fallen to a level which gives a competitive advantage to home against foreign goods adequate to restore the balance without unemployment, the bank rate policy has finally done its work. (It did not of course occur to the Cunliffe Committee to inquire whether any such level of wages exists, or what would be the standard of life when it was reached.)

As a theoretical construction, the argument, with the emendations suggested above, seems coherent and since before 1914 the gold standard system did in fact operate successfully, at least from a British point of view, it might be argued that the theory can claim to be rooted in experience. But was it in fact so ?

Look back to the first sentence quoted. The Committee take as typical of a situation in which gold is flowing out of London the case of an unfavourable balance of trade, by which they clearly mean a deficit on income account. But gold movements do not react to the balance on income account but to a discrepancy between the balance on income account and the movement of capital. In an atmosphere of political security and unquestioned faith in exchange rates, movements of hot money can be neglected and the flow of capital is dominated by new lending. Now, when Great Britain was a major source of finance for overseas development and also a major source of production of capital goods, excess exports and excess lending went hand in hand (in a world slump exports and lending fell together) so that the discrepancies which the gold-standard mechanism had to correct were probably never large, and certainly never reached the proportions of a modern balance of payments crisis. Moreover, throughout the period to which the orthodox theory is supposed to apply, the British balance on income account was consistently favourable. An outflow of gold did not indicate a deficit but merely a tendency to excessive lending. Thus the task which the bank-rate policy actually had to perform was not to redress an excess of imports by creating unemployment, but to prevent the outflow of capital from exceeding the surplus on income account.

The orthodox theory, as presented in the Cunliffe Report, cannot claim any support from history. On the contrary, when we recollect that their recommendations were in fact carried out in 1925, the appeal to orthodoxy appears rather as a plea to forget the lessons of experience.

*Cambridge.*

## XIII

### By Edward Nevin

### Introduction

In the change in British monetary policy which occurred in November 1951, the drastic reduction of the banks' liquid assets through the funding of Treasury Bills was a major instrument—' by far the biggest force in producing so rapid and yet so smooth a transformation ', as *The Economist* described it.[1] In his previous article in this symposium, Mr. Johnson has pointed out the unorthodoxy of the use of the banks' liquidity structure, rather than their cash basis, in the regulation of credit. It is the object of this article to discuss the factual basis for the current doctrines concerning the importance which British commercial banks attach to the proportion of their total assets which are held in a liquid form.

For obvious reasons, recourse must be had to pre-war statistics; the war and post-war years, up to November 1951, were featured by abnormal liquidity in the banking system and no question of a shortage of liquid assets has ever arisen. The starting point has been taken as 1925 since this year can presumably be taken to mark the return to such normality as the economic system ever attained in the inter-war years. A word is perhaps necessary concerning the relevance of the 1930s in an analysis of this kind. It has been suggested by some observers that the experience of the years 1932 onwards should be ignored because of the cheap money policy which the authorities were then pursuing and the assumption that action could always be relied upon to prevent any real stringency developing. The facts just do not bear out this assertion. Liquid assets were in short supply almost throughout the 1930s; what is more important, the securities market was by no means cossetted in these years. In five of the six years 1934–39, the degree to which the price of Consols fell—*i.e.* the range between the highest and lowest price recorded—was considerably greater than the maximum fall in Consols between the change in monetary policy in November 1951 and the low point reached at the end of June 1952. There is no real justification for ignoring these years, therefore, in an examination of the banks' liquidity practices.

### The Pre-War Liquid Assets Ratio

The first question to be answered then is this : did the banks in fact have some definite ratio of liquid assets to total deposits which they sought to maintain ? It is generally said that they like to have a minimum of 30 per cent of their assets in a liquid form. But it is quite impossible to find any statement by a practising banker which specifies this figure of 30 per cent

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[1] December 18th, 1951, p. 1417.

—or, for that matter, any figure at all.[1] The only precise figures given before the MacMillan Committee were those of the representative of the Midland Bank, who said that 11 per cent of the bank's assets were usually in the form of cash, 3.5 per cent in the form of cheques in the course of collection, 7 per cent in money at call, and 15 per cent in the form of bills.[2] This gives a total of 36.5 per cent. This is one of the very rare occasions upon which a prominent banker has described the precise asset-structure of his bank. Clearly, recourse must be had to the statistics to discover what the practice of the banks was.

Here an important point should be made. While, for a rough guide to movements, the aggregate figures for all the clearing banks (published before the war by the Bank of England) are adequate enough, they will not do for any detailed examination of banking practices. Firstly, because the aggregate figures may well conceal important movements in the returns of individual banks. The total figure for liquid assets, for example, may be unchanged between one month and another, but in that period the liquidity of some banks may have increased while that of others may have fallen below some crucial level. Secondly, such aggregate figures exclude, quite rightly, the item ' cheques in course of collection ' and other items in transit. Such balances are meaningless for the system as a whole; obviously, they do not add to the liquidity of the banks taken together. But for the individual bank they are not to be so easily ignored. There is no conclusive reason for supposing that the individual banker regards cheques in the course of collection as anything but liquid assets. He is concerned with the liquidity of *his* bank, not with that of the banking system as a whole. At the same time, such balances are certainly not liquid in the sense of being fully under the banker's control. The fact that these balances are put second only to cash in the descending order of liquidity of the bank balance sheet, however, suggests that, all in all, it is convenient for practical purposes to classify them as liquid assets, and they have therefore been included in the liquidity ratios of each bank for the purposes of the present analysis. This is not a vital point, partly because such balances are relatively stable both between the main clearing banks and for each individual bank,[3] but mainly because they are certainly not ' risk assets '—and it is probably more accurate to speak of a 70 per cent risk asset ratio than a 30 per cent liquidity ratio. What the banks may watch, in other words, is the proportion which the total of their investments and advances bears to total deposits; the converse ' liquidity ratio ' more often occupies attention presumably because it is this element which is liable in practice to sudden and disconcerting changes.[1]

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[1] *The Economist*, for example, refers to ' the 30 per cent that was the conventional liquidity minimum in the days of effective monetary discipline '. (Nov. 17th, 1951, p. 1220) Elsewhere it adumbrates 30 per cent as ' the normal working minimum ' (Dec. 8th, 1951, p. 1417). The authorities themselves appear to hold the view that 30 per cent was a ' conventional minimum ' (*Economic Survey for* 1952. Cmd. 8509, p. 43).

[2] Committee on Finance and Industry, *Minutes of Evidence*, Q. 871.

[3] The Big Five, for example, showed before the war a fairly constant proportion of assets under this heading, the amount moving only occasionally beyond a range of 2½ per cent to 3½ per cent of total deposits. The other, smaller clearing banks tended to have rather a larger proportion of their assets under this heading, but again the range of variation is not very wide taking one year with another.

Taking liquid assets as including, then, (*a*) cash in hand and at the Bank of England, (*b*) cheques in course of collection (and other items in transit, if shown separately), (*c*) money at call and short notice, and (*d*) bills discounted, an analysis has been made of the monthly returns of each of the clearing banks during the years 1925–1939 inclusive.[2] The annual average cash and

TABLE IA

*Average Cash Ratio (A) and Liquidity Ratio (B)*
*The Big Five*

| | *Barclays* | | *Lloyds* | | *Midland* | | *Nat. Prov.* | | *Westminster* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | A | B | A | B | A | B | A | B | A | B |
| 1925 | 11.5 | 34.3 | 11.2 | 35.1 | 14.8 | 36.9 | 11.1 | 35.7 | 10.4 | 39.2 |
| 1926 | 11.5 | 34.5 | 11.5 | 33.3 | 14.4 | 36.2 | 11.0 | 35.4 | 10.4 | 39.2 |
| 1927 | 11.2 | 34.4 | 11.8 | 34.4 | 13.3 | 37.0 | 11.0 | 34.5 | 10.3 | 38.6 |
| 1928 | 10.6 | 35.7 | 11.6 | 36.5 | 12.2 | 37.1 | 11.1 | 35.3 | 10.3 | 41.2 |
| 1929 | 10.5 | 34.5 | 11.1 | 35.2 | 11.2 | 35.8 | 11.1 | 33.3 | 10.3 | 38.0 |
| 1930 | 10.6 | 36.0 | 10.7 | 35.7 | 11.1 | 37.0 | 10.9 | 35.4 | 10.2 | 40.2 |
| 1931 | 10.3 | 35.9 | 10.6 | 34.5 | 10.6 | 36.0 | 10.3 | 34.0 | 10.2 | 35.7 |
| 1932 | 10.7 | 35.7 | 10.8 | 39.5 | 10.5 | 35.6 | 10.2 | 36.6 | 10.2 | 38.9 |
| 1933 | 10.3 | 36.9 | 11.2 | 38.1 | 12.3 | 36.6 | 10.5 | 37.1 | 10.2 | 38.4 |
| 1934 | 10.3 | 33.2 | 12.3 | 35.5 | 12.6 | 33.7 | 11.5 | 32.9 | 10.2 | 34.1 |
| 1935 | 10.7 | 34.4 | 11.7 | 35.8 | 11.3 | 33.0 | 10.4 | 33.0 | 10.2 | 35.0 |
| 1936 | 10.2 | 34.3 | 10.5 | 36.1 | 10.7 | 36.8 | 10.1 | 34.4 | 10.2 | 35.9 |
| 1937 | 10.4 | 31.9 | 10.3 | 34.1 | 10.5 | 34.1 | 10.2 | 31.3 | 10.2 | 35.3 |
| 1938 | 10.8 | 33.1 | 10.9 | 32.5 | 11.2 | 33.7 | 10.3 | 31.2 | 10.2 | 34.0 |
| 1939 | 10.9 | 32.8 | 11.0 | 33.9 | 11.4 | 30.6 | 11.1 | 30.6 | 10.3 | 33.1 |
| *Average* | *10.7* | *34.5* | *11.1* | *35.3* | *11.9* | *35.3* | *10.7* | *34.0* | *10.3* | *37.1* |

TABLE IB

*Other Clearing Banks*

| | *Coutts* | | *Glyn Mills* | | *Martins* | | *National* | | *Williams Deacons* | |
|---|---|---|---|---|---|---|---|---|---|---|
| 1925 | 8.5 | 36.2 | 10.9 | 37.2 | 10.4 | 25.9 | 10.2 | 27.4 | 11.9 | 31.2 |
| 1926 | 8.7 | 30.8 | 9.6 | 34.8 | 10.5 | 26.5 | 10.1 | 28.4 | 12.1 | 30.0 |
| 1927 | 8.5 | 33.0 | 10.3 | 37.9 | 10.7 | 26.6 | 10.1 | 29.3 | 11.7 | 30.4 |
| 1928 | 8.7 | 31.6 | 10.1 | 32.7 | 10.5 | 27.0 | 10.1 | 29.5 | 11.1 | 30.9 |
| 1929 | 8.4 | 30.3 | 10.3 | 35.0 | 10.4 | 28.3 | 9.2 | 28.1 | 10.7 | 29.6 |
| 1930 | 8.6 | 31.4 | 10.4 | 32.9 | 10.6 | 29.5 | 8.6 | 24.5 | 10.6 | 27.6 |
| 1931 | 8.5 | 34.7 | 10.4 | 33.0 | 10.2 | 30.5 | 8.4 | 22.9 | 10.6 | 27.3 |
| 1932 | 8.6 | 39.0 | 10.4 | 30.4 | 10.1 | 32.5 | 8.0 | 25.6 | 10.6 | 34.1 |
| 1933 | 8.4 | 35.2 | 10.5 | 26.6 | 10.1 | 29.5 | 7.9 | 25.2 | 10.5 | 36.9 |
| 1934 | 8.3 | 30.7 | 10.3 | 33.5 | 10.1 | 24.3 | 8.2 | 23.1 | 10.5 | 36.8 |
| 1935 | 8.3 | 32.2 | 10.2 | 32.4 | 10.2 | 26.7 | 8.5 | 25.6 | 10.6 | 38.9 |
| 1936 | 8.3 | 30.8 | 10.1 | 34.7 | 10.1 | 25.5 | 8.7 | 27.5 | 10.3 | 38.0 |
| 1937 | 8.2 | 26.2 | 10.3 | 39.8 | 10.1 | 23.9 | 8.8 | 26.6 | 10.1 | 33.4 |
| 1938 | 8.3 | 27.3 | 10.2 | 40.6 | 10.2 | 24.8 | 8.9 | 24.2 | 10.3 | 33.3 |
| 1939 | 8.6 | 28.5 | 10.7 | 43.0 | 10.3 | 24.4 | 9.2 | 23.0 | 10.4 | 35.2 |
| *Average* | *8.5* | *31.9* | *10.3* | *35.0* | *10.3* | *27.1* | *9.0* | *26.1* | *10.8* | *32.9* |

NOTE.—The cash ratio shows the ratio of cash to total current and deposit accounts; in the case of the National Bank the ratio is that of cash to total deposits *plus* notes issued. The liquidity ratio is the proportion to total deposits of cash, balances in ourse of collection, money at call and short notice and bills discounted.

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[1] It is worth recording that all the calculations which follow have been repeated with balances in course of collection omitted from liquid assets. While space does not permit the inclusion of the figures, the results, as might be expected, were substantially identical with those discussed here.

[2] The District Bank has not been included in the analysis since there is little point in taking the figures for the years 1936 onwards, and figures for previous years are not readily accessible.

liquidity ratios are shown for each bank in Table I. A glance at this table will bring out the very limited usefulness of talking about a ' 30 per cent ratio ' at all. Not one of the five big banks maintained a ratio of anything very close to 30 per cent, the actual ratios for the whole period of fifteen years taken together ranging from 34.0 per cent in the case of the National Provincial to 37.1 per cent in the case of the Westminster. When the remaining clearing banks are considered, the range of practices becomes even wider. Two banks—Martins and the National—maintained an average liquidity ratio consistently below 30 per cent. Indeed, the annual average fell below 25 per cent in four years with Martins and in five years in the case of the National. Glyn Mills, on the other hand, maintained an average of 35 per cent over the period as a whole, and kept an average liquidity ratio of more than 40 per cent during two years. To speak of any one liquidity ratio is, therefore, to imply a much greater uniformity of practice than the statistics indicate.

Nor can any generalisation safely be made about the relationship between the cash and liquidity ratios. It might logically be argued that a bank with a high cash ratio would not need to keep quite as great a proportion of its assets in a liquid form as the average, while one which maintained a cash ratio rather lower than average might compensate with an unusually high ratio of liquid assets taken as a whole. Two of the five big banks maintained a cash ratio over the period as a whole of over 11 per cent and a liquid-assets ratio of over 35 per cent. Two others, on the other hand—Barclays and the National Provincial—kept both ratios at a lower average, while the Westminster maintained a lower cash ratio and a higher liquidity ratio. Much the same is true of the other banks. The National, with an unusually low cash ratio, has the lowest average liquidity ratio ; Glyn Mills and Martins both kept an average cash ratio of 10.3 per cent but widely different liquidity ratios. It is quite obvious that to explain both the absolute level of liquidity ratios, and their relationship with cash ratios, recourse must be had to the policy and circumstances of each bank in particular, and generalisation is pointless.

## The Stability of the Ratio

It may be argued that, from the point of view of credit control, the absolute level of the liquidity ratios maintained by different banks is of less importance than the degree to which they maintained stability of those ratios. It is of the essence of central bank control in a modern monetary system that certain ratios—whatever they may be—are maintained, and movements one way or the other are corrected by appropriate adjustments in the general level of liabilities. To what degree, then, did the clearing banks maintain stability of their individual ratios ? In Table II the variabilities of the two ratios are shown for each year. Variability has here been measured in an extremely simple manner—the variability in each year is taken as the

TABLE IIA

*Variability of Cash Ratio (A) and Liquidity Ratio (B)*
*The Big Five*

| | *Barclays* | | *Lloyds* | | *Midland* | | *Nat. Prov.* | | *Westminster* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | A | B | A | B | A | B | A | B | A | B |
| 1925 | 1.7 | 3.4 | 1.0 | 3.1 | .7 | 3.5 | .2 | 3.2 | .6 | 6.4 |
| 1926 | 1.3 | 4.6 | 1.0 | 4.3 | .9 | 3.2 | .1 | 3.0 | .3 | 2.7 |
| 1927 | 1.4 | 4.4 | .8 | 7.8 | 1.4 | 2.8 | .3 | 4.0 | .4 | 3.2 |
| 1928 | 1.2 | 3.8 | .7 | 3.0 | .7 | 4.1 | .3 | 5.6 | .6 | 3.4 |
| 1929 | 2.1 | 3.3 | 1.2 | 3.0 | 1.4 | 4.2 | .4 | 6.8 | .8 | 3.3 |
| 1930 | 1.9 | 5.1 | 1.2 | 5.7 | .7 | 8.1 | .7 | 8.4 | .7 | 7.0 |
| 1931 | 1.4 | 5.3 | .4 | 5.0 | .7 | 10.6 | 1.0 | 7.2 | .4 | 9.3 |
| 1932 | 1.1 | 8.3 | 1.8 | 9.2 | .9 | 9.6 | .4 | 7.5 | .5 | 12.0 |
| 1933 | 2.2 | 5.8 | 3.5 | 7.1 | 3.5 | 7.9 | 2.0 | 4.7 | .2 | 7.0 |
| 1934 | 1.5 | 4.2 | 4.0 | 4.2 | 4.3 | 3.0 | 2.5 | 5.2 | .4 | 4.5 |
| 1935 | 2.0 | 4.9 | 3.8 | 6.0 | 3.5 | 8.1 | 2.4 | 6.6 | .4 | 4.4 |
| 1936 | .7 | 5.2 | 4.2 | 5.6 | 2.5 | 2.6 | 1.0 | 4.2 | .5 | 5.1 |
| 1937 | 1.1 | 5.3 | 1.0 | 3.4 | .9 | 6.4 | 1.0 | 6.0 | .4 | 5.9 |
| 1938 | 2.3 | 4.1 | 2.2 | 6.0 | 1.7 | 7.4 | 1.0 | 3.7 | .3 | 4.3 |
| 1939 | 3.0 | 8.9 | 2.0 | 9.9 | 3.9 | 6.0 | 3.0 | 12.2 | 1.5 | 6.9 |
| *Average* | *1.7* | *5.1* | *1.9* | *5.6* | *1.8* | *5.8* | *1.1* | *5.9* | *.5* | *5.7* |

TABLE IIB

*Other Clearing Banks*

| | *Coutts* | | *Glyn Mills* | | *Martins* | | *National* | | *Williams Deacons* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | A | B | A | B | A | B | A | B | A | B |
| 1925 | .9 | 7.9 | 2.7 | 13.8 | 1.5 | 8.5 | .7 | 2.8 | .5 | 8.7 |
| 1926 | 1.0 | 9.4 | 3.3 | 18.6 | .4 | 4.7 | .4 | 3.0 | .4 | 9.6 |
| 1927 | .7 | 10.0 | 1.9 | 16.6 | .7 | 4.5 | .3 | 1.2 | .6 | 3.7 |
| 1928 | .7 | 9.9 | .8 | 15.7 | .2 | 4.4 | .6 | 2.4 | 1.3 | 5.7 |
| 1929 | .6 | 11.9 | .9 | 12.6 | 1.1 | 9.4 | 1.4 | 2.0 | .6 | 8.4 |
| 1930 | .7 | 9.6 | 2.7 | 14.6 | .5 | 9.0 | 1.0 | 3.9 | .6 | 9.1 |
| 1931 | .9 | 12.5 | 2.4 | 12.4 | .5 | 6.1 | .9 | 1.2 | .6 | 6.5 |
| 1932 | 1.3 | 13.5 | 1.2 | 9.4 | .3 | 2.9 | .9 | 6.7 | .8 | 15.5 |
| 1933 | 1.0 | 13.9 | 1.7 | 12.8 | .4 | 6.2 | 1.3 | 3.2 | .8 | 6.1 |
| 1934 | .8 | 4.9 | .7 | 7.1 | .6 | 7.3 | 1.0 | 2.4 | .7 | 5.6 |
| 1935 | .5 | 7.1 | .9 | 8.6 | .3 | 7.8 | 1.2 | 2.1 | .9 | 6.6 |
| 1936 | .7 | 16.5 | .5 | 17.3 | .4 | 6.6 | .5 | 4.0 | .7 | 6.4 |
| 1937 | .3 | 8.0 | 1.6 | 11.7 | .3 | 5.9 | 1.2 | 3.1 | .3 | 4.9 |
| 1938 | .6 | 12.7 | .6 | 8.7 | .4 | 4.6 | 1.1 | 6.4 | .6 | 3.5 |
| 1939 | 3.4 | 12.6 | 6.3 | 20.4 | 1.6 | 10.8 | 4.7 | 4.9 | 2.5 | 10.0 |
| *Average* | *.9* | *10.7* | *1.9* | *13.4* | *.6* | *6.6* | *1.1* | *3.3* | *.8* | *7.4* |

NOTE. The figures show the difference in each year between the highest and lowest ratio of cash or liquid assets to total deposits.

difference between the highest and lowest average monthly ratio—but this is quite sufficient for the present purpose.[1]

Of the five main banks, something rather more general may be said here. Over the period as a whole, each allowed an average variation of between

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[1] It must of course be borne in mind when considering the figures used in this section that this method indicates *absolute* and not relative variability, and that a given percentage change will have a greater proportionate significance if it occurs in the cash ratio than if it occurs in the secondary ratio, simply because liquid assets as a whole form a larger element in total assets than cash taken alone. To estimate the *relative* variability, the absolute figures would have to be expressed as fractions of the average cash or secondary ratio, as the case may be. (If this is done, the secondary ratio will still generally be found to be distinctly less stable than the cash ratio.) The absolute ranges of variation are used in the text in order to bring out the essential point—the width of the range within which the banks are prepared on occasion to allow total liquid assets to vary.

1 per cent and 2 per cent in its cash ratio, with the exception of the Westminster, which maintained a quite extraordinary stability in its published cash ratio. They each, on the other hand, allowed the published liquidity ratio to vary on average between 5 per cent and 6 per cent—the average variations are within a strikingly narrow range in this case. This variation is sufficiently great to throw some doubt upon the usefulness of the liquidity ratio as a lever of monetary policy. More important, however, is the indication given in the table of the degree to which the banks were prepared to allow the ratio to vary. Three of the banks—the Midland, Lloyds and the Westminster—permitted their liquidity ratio to vary on occasion by more than 10 per cent; the other two, at the same time, showed almost as much flexibility in liquidity standards, Lloyds' ratio varying by 9.9 per cent in 1939 and Barclays' by 8.9 per cent in the same year. It is this potential variation which limits the reliance which could be placed on the secondary ratio as a means of credit control. Only twice in 15 years is there a case within the circle of the big five of the published cash ratio varying by more than 4 per cent—the Midland in 1934, Lloyds in 1936. Only in eight cases, indeed, did the published cash ratio show a range greater than 3 per cent. The secondary ratio is, by comparison, very much less rigid, variations of 7 per cent—8 per cent in a single year being by no means unusual. It has to be remembered, of course, that the published cash ratio is probably stabilised by the practice of window-dressing; there is no way of assessing the degree to which variation in the actual cash ratio was concealed in this way. But it seems unlikely that window-dressing would account wholly for the greater variability in the secondary ratio as compared with the cash ratio.

These remarks apply even more forcibly to the remaining clearing banks. Once again, there is evidence of a variation of practice which defies generalisation. While the cash ratios are, on the whole, distinctly more stable than in the case of most of the bigger banks, in four of the five small banks the variation allowed in the liquidity ratio is even greater. Glyn Mills, for example, allowed its secondary ratio to vary by more than 20 per cent in 1939, while there are no less than 22 examples of the ratio varying by 10 per cent or more in a single year. The extremes here are a variability of the average secondary ratio for the whole period twelve times as great as that of the cash ratio, in the case of Coutts, and eleven times as great with Martins, and, at the other end of the scale, a mere three times as great in the case of the National. It is difficult, in the light of these figures, to speak of the banks generally as seeking to maintain any fixed ratio at all ; they appeared merely to aim at keeping liquid assets within a range which is in all cases quite wide, and in some cases extremely wide.

## The Liquidity Ratio and Secondary Movements

The answer to the first question posed appears to be, then, that the banks do not have any one ratio for liquid assets at which they aim—and certainly not the 30 per cent often spoken of —and that they are prepared to allow liquid assets to comprise a range of ratios rather than a fixed ratio of total assets. The second, and more important, question is: do the banks contract credit when liquid assets fall below some minimum level? It is this which matters in practice. The question also applies logically in reverse, of course: do the banks expand credit when liquid assets exceed a certain maximum level? Since at the present time monetary policy is concerned with restricting rather than expanding credit, it will be convenient to confine the discussion to the first case. Those who subscribe to this type of liquidity-ratio doctrine argue that, once liquid assets fall below some minimum level, the banks will contract their holdings of other assets—even though their cash is great enough to support the existing level of deposits—until liquid assets are restored to that ratio of deposits which the banks regard as a safe minimum.[1] If this is the practice of the banks, it would be seen in what may be called a *secondary* contraction of deposits—that is, the fall in liquid assets will in itself cause a (primary) fall in deposits, and in order to restore the minimum liquidity ratio the banks sell investments or reduce advances (the secondary contraction). This secondary movement in any month would therefore consist of the fall in total deposits *minus* the fall in liquid assets. If, for example, the liquidity ratio fell below the minimum because of a fall in bills discounted amounting to £10 m., and total deposits fell by the same amount, there would have been no secondary movement. The banks would appear to be unmoved by the fall in bills. If, on the other hand, total deposits were unchanged, there would have been a secondary *expansion* of £10m.—some other assets must have risen by £10 m. to offset the fall in bills. In this case, the banks would have shown that they regarded liquid and non-liquid assets as competitive, a decline in the one being compensated by a rise in the other. If, finally, deposits had fallen by more than £10 m., there would have been a secondary *contraction*—some assets other than bills must have been reduced. Here the banks would have been indicating their belief that liquid and non-liquid assets were complementary, a decline in one necessitating a decline in the other. The proponents of the secondary ratio theory argue the final case; they maintain that when liquid assets fall below some critical point a secondary contraction will occur as the banks seek to prevent the decline in the secondary ratio.

In order to test this version of the theory against the facts, it is necessary to postulate some such critical level at which the secondary movement will begin. From what has been said already, it will be obvious that it is impossible to determine from the statistics any minimum level or common average which the banks seek to maintain. It is proposed here to test the argument against two standards—one severe and the other less so. Firstly, is 30 per cent the critical point at which the banker cries, ' So far and no further '? To answer the question, the data for eight of the ten clearing banks[2] have been examined for each month of the period 1925–39. In each instance where the liquidity ratio of each bank fell below 30 per cent the secondary movement has been calculated, and the results tabulated in Table III according as to whether the fall in liquid assets below 30 per cent was accompanied by a fall or rise in some other non-liquid asset, or whether there was no secondary movement whatever.[1] It will be seen that the results of the analysis are quite overwhelmingly against the liquidity-ratio theorists. Out of 55 cases in which liquid assets—even on this ' gross ' basis—fell below 30 per cent, in only 10 was this associated with a secondary contraction in non-liquid asssets. In 45 cases the banks actually *expanded* other assets so as to offset partly or wholly the fall in liquid assets. Of these 10 cases where the theory applies, only three involved one of the big five banks. The fact is, of course, that it is quite difficult to find occasions on which the liquid assets of one of the big five banks fell below the 30 per cent level—only 11 of the 55 cases summarised in Table III relate to one or other of the big five. For this reason, a second, and less exacting, standard, has been taken. The same procedure as before has been followed wherever the liquidity ratio fell below the average for the bank concerned for the whole period, the averages being those shown in Table I; the results are shown in Table IV.[2] Once again the facts are overwhelmingly against the theory of the secondary ratio—in three cases out of four a fall in liquid assets was accompanied by an expansion rather than a reduction in other assets. This includes 69 cases involving one or other of the big five; in only 16 of them—less than a quarter—was there a secondary reduction in non-liquid assets.

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[1] See, for example, League of Nations *Monetary Review*, 1938–39, p. 54.

[2] Since Martins and the National kept during the period, on average, a secondary ratio of distinctly less than 30 per cent it is obviously pointless to include them in this investigation.

TABLE III

*Secondary Movement in Deposits : Liquidity Ratio Falling Below 30 percent*

| | *Number of cases* | *Secondary deposit movement* | | |
|---|---|---|---|---|
| | | *Increase* | *Neutral* | *Decrease* |
| Barclays ... ... ... | 1 | 1 | — | — |
| Coutts ... ... ... | 20 | 19 | — | 1 |
| Glyn Mills ... ... | 12 | 8 | — | 4 |
| Lloyds ... ... ... | 1 | 1 | — | — |
| Midland ... ... ... | 2 | 2 | — | — |
| National Prov. ... ... | 6 | 4 | — | 2 |
| Westminster ... ... | 1 | — | — | 1 |
| Wms. Deacons ... ... | 12 | 10 | — | 2 |
| | 55 | 45 | | 10 |

It is possible to analyse this a little further. Of the 32 cases where a secondary contraction occurred, 16 involved one of the big five. Space does not permit an examination of every one of the 32 cases, but it is instructive to

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[2] It should be noted that, in order to reduce the number of cases of manageable proportions, for the purposes of this table consecutive months in which the liquidity ratio was below the critical level were treated as one. That is, if the liquidity ratio was 32 per cent in January, fell to 29.1 per cent in February, 28.7 per cent in March, and rose to 31.1 per cent in April, February and March would be treated as one case, the level of liquid assets and of total deposits at the end of March being compared with those at the end of January.

[2] A procedure similar to that adopted for Table III has been adopted with regard to consecutive months.

TABLE IV

*Secondary Movement in Deposits: Liquidity Ratio Falling Below Average*

| | Number of cases | Secondary deposit movement | | |
|---|---|---|---|---|
| | | Increase | Neutral | Decrease |
| Barclays ... ... ... | 19 | 15 | — | 4 |
| Coutts ... ... ... | 20 | 18 | — | 2 |
| Glyn Mills ... ... | 22 | 15 | 1 | 6 |
| Lloyds ... ... ... | 17 | 11 | 1 | 5 |
| Martins ... ... ... | 14 | 11 | — | 3 |
| Midland ... ... ... | 13 | 12 | — | 1 |
| National .. ... ... | 10 | 6 | — | 4 |
| National Prov. ... ... | 12 | 7 | — | 5 |
| Westminster ... ... | 8 | 6 | 1 | 1 |
| Wms. Deacons ... ... | 8 | 5 | 2 | 1 |
| | 143 | 106 | 5 | 32 |

consider the 16 cases in which a member of the big five pursued a secondary contraction of deposits when liquid assets fell below their average level. Did these cases have some factor in common which would explain why a secondary contraction was undertaken in these cases and not in the others? Do they indicate the critical level of liquid assets for each bank?—this may be sufficiently below the average to explain why three times out of four a liquidity ratio below average was associated with an expansion of other assets. In Table V the sixteen cases are shown according to the months in which they occurred, together with the liquidity ratio shown at the time in the monthly returns. The first point to note is that it is clearly not the liquidity ratio as such which holds the secret. On the whole, the ratios in the months concerned were relatively high, and quite close to the averages for the whole period. It is in every case possible to find for each bank cases where secondary expansions occurred with even lower liquidity ratios. The second, and more revealing, feature of the table is the very marked bunching of these cases around a common period. Of the total of sixteen, all but four occur within the three years March 1929—May 1932, and only two occur after 1932.[1]

TABLE V

*Occasions of Secondary Deposit Contraction*

| | | Dates | Average liquidity ratio |
|---|---|---|---|
| *Barclays* ... | 1 | February—May 1926 ... ... ... ... | 33.2 |
| | 2 | March—May 1929 ... ... ... ... | 33.4 |
| | 3 | October—November 1929 ... ... ... | 34.2 |
| | 4 | November 1931 ... ... ... ... ... | 34.4 |
| *Lloyds* ... | 1 | March 1928 ... ... ... ... ... | 34.9 |
| | 2 | November 1929 ... ... ... ... ... | 34.9 |
| | 3 | January—April 1930 ... ... ... ... | 33.7 |
| | 4 | October—November 1931 ... ... ... | 34.5 |
| | 5 | January—April 1932 ... ... ... ... | 35.0 |
| *Midland* ... | 1 | September 1929 ... ... ... ... ... | 35.2 |
| *Nat. Prov.* ... | 1 | May—June 1931 ... ... ... ... | 32.6 |
| | 2 | August—November 1931 ... ... ... | 33.2 |
| | 3 | February—April 1932 ... ... ... ... | 33.2 |
| | 4 | April 1934 ... ... ... ... ... | 32.7 |
| | 5 | November 1935 ... ... ... ... ... | 33.5 |
| *Westminster* | 1 | November 1931—May 1932 ... ... ... | 34.7 |

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[1] It is worth note that the other sixteen cases involving the smaller clearing banks yield, on analysis, very much the same result. Of the sixteen, nine fall within the period 1929–32, and only 5 occur after 1932.

Even these latter cases are revealing; they both involve the National Provincial, and are exceptions in little more than a technical sense. In 1934, the contraction occurred only because non-liquid assets failed to increase as rapidly as liquid assets, the latter *rising* from 30.9 per cent to 32.7 per cent of total deposits in the month concerned; in November 1935, the secondary contraction amounted to a mere £0.2 million. Without straining the facts, therefore, it can be said that the secondary contractions occurred almost wholly in the terrible years 1929–32. The conclusion is plain; the only period in which the secondary liquidity ratio really played the role ascribed to it in this version of the liquidity-ratio theory was that in which every financial institution in the world was desperately seeking to liquidate its assets.

## LIQUIDITY AND RISK SENSITIVITY

The third question involves a version of the liquidity ratio theory which has at first much to commend it on grounds of common-sense. That is, do the banks become increasingly unwilling to expand the total of their ' risk ' assets—investments and advances—as the proportion of liquid assets declines ? The question is testing a version of the liquidity theory in which there is no attachment to rigid ratios, but simply the assertion that, with liquidity falling, the banks will tend to expand advances only at the expense of selling investments rather than by adding to the total of their risk assets.[1] Conversely, the argument runs, when the banks' liquidity is rising they will be more willing to see the total of their risk assets rising, and will tend more to expanding advances without selling investments, and, indeed, may even increase both types of asset together.

It must be admitted that this question is not easily answered with the statistics. The increased willingness or unwillingness of the banks to increase advances postulated by the argument may well take the form of an easing or tightening of credit requirements and conditions which cannot be reflected in bank returns. The total of advances will, however, afford a fairly reliable guide, since a change in the availability of bank advances will presumably cause a corresponding change in their total ultimately, unless the change in bank policy is offset by some strong trend in bank borrowing due to outside causes. The statistics for the ten clearing banks have therefore been analysed in order to extract some evidence bearing on this argument. For each bank, the figures for advances and investments have been compared for each month, or periods of consecutive months, in which the liquid assets ratio was either rising or falling; in Tables VI and VII these have been classified according as investments rose, remained constant, or fell with the change in advances, periods of falling liquidity being compared in each case with those of rising liquidity.

What would one expect the results to be if this version of the liquidity-ratio theory were supported by the facts ? Briefly, when advances rose one

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[1] See, for example, *The Economist*, Nov. 10th, 1951, p. 1125.

TABLE VI

*Advances Rising*

| | *Rising liquidity* | | | *Falling liquidity* | | |
|---|---|---|---|---|---|---|
| | *Number of cases in which* | | | *Number of cases in which* | | |
| | *I*=+ | I=*0* | *I*=— | *I*=+ | *I*=*0* | *I*=— |
| Barclays | 10 | 3 | 7 | 15 | 2 | 14 |
| Coutts | 4 | 5 | 3 | 8 | 18 | 5 |
| Glyn Mills | 3 | 3 | 7 | 21 | 3 | 15 |
| Lloyds | 1 | 4 | 14 | 10 | 1 | 12 |
| Martins | 2 | 0 | 10 | 14 | 0 | 8 |
| Midland | 3 | 1 | 12 | 18 | 2 | 9 |
| National | 0 | 5 | 7 | 5 | 15 | 9 |
| National Provincial | 7 | 2 | 10 | 11 | 1 | 17 |
| Westminster | 6 | 5 | 9 | 9 | 6 | 10 |
| Williams Deacons | 1 | 8 | 5 | 8 | 6 | 7 |
| | 37 | 36 | 84 | 119 | 54 | 106 |
| Percent of total | 24% | 23% | 53% | 43% | 19% | 38% |

TABLE VII

*Advances Falling*

| | *Rising liquidity* | | | *Falling liquidity* | | |
|---|---|---|---|---|---|---|
| | *Number of cases in which* | | | *Number of cases in which* | | |
| | *I*=+ | *I*=*0* | *I*=— | *I*=+ | *I*=*0* | *I*=— |
| Barclays | 9 | 2 | 10 | 3 | 1 | 2 |
| Coutts | 10 | 12 | 4 | 4 | 4 | 1 |
| Glyn Mills | 12 | 4 | 28 | 13 | 0 | 4 |
| Lloyds | 14 | 1 | 6 | 9 | 3 | 2 |
| Martins | 17 | 3 | 7 | 12 | 1 | 4 |
| Midland | 12 | 0 | 11 | 9 | 1 | 3 |
| National | 5 | 9 | 12 | 4 | 7 | 1 |
| National Provincial | 11 | 4 | 10 | 7 | 1 | 5 |
| Westminster | 10 | 4 | 6 | 10 | 2 | 2 |
| Williams Deacons | 9 | 6 | 5 | 5 | 5 | 2 |
| | 109 | 45 | 99 | 76 | 25 | 26 |
| Percent of total | 43% | 18% | 39% | 60% | 20% | 20% |

NOTE. These tables represent an analysis of the reaction upon the total of investments held by ten clearing banks of changes in advances under rising or falling liquidity conditions —i.e. according as the proportion of liquid assets was rising or falling in the periods concerned. The cases comprise single months except where a rise or fall in the liquidity—ratio was continued through consecutive months, in which case the change over the several months has been treated as one case. I=+ means that the total of investments rose; I=0 that it was unchanged; I=— that it fell.

would expect investments to fall less, or rise more, in periods of rising liquidity than in periods of falling liquidity. Similarly, when advances fell one would expect investments to rise more, and fall less, in months in which liquidity was rising than in those in which liquidity was falling. The data given in Tables VI and VII not only fail to substantiate this but tend, indeed, to indicate the opposite. Consider first Table VI, where a total of 436 cases in which advances rose have been analysed. Firstly, the degree to which such increases had no effect upon the total of investments appears to be almost entirely unaffected by the contemporaneous movement in the proportion of assets held in a liquid form. When liquidity was rising, this stability of investments was found in 23 per cent of the cases analysed, compared with 19 per cent when liquidity was falling. This proportion it is worth noting, was almost precisely the same in cases in which advances were falling, as will be seen from Table VII ; this suggests that the decision to neither increase nor decrease total holdings of securities is not materially affected by the banks' liquidity position. Secondly, the proportion of cases in which investments rose at the same time as advances was in fact lower when liquidity was rising than when it was falling—24 per cent compared with 43 per cent—a tendency in direct contradiction with this version of the liquidity argument. Finally, advances were increased at the expense of investments in a higher proportion of cases when liquidity was rising than in those when liquidity was falling—53 per cent compared with 38 per cent—again challenging the argument. Table VII, analysing 380 cases in which advances fell, tells much the same story; when liquidity was rising, the fall in advances was accompanied by a rise in investments in a smaller proportion of cases than when liquidity was falling, while investments fell in a higher proportion of cases in the former group than in the latter.

It must be admitted that a statistical analysis of this kind cannot provide a completely unanswerable proof or disproof of this version of the liquidity theory. It may be that time lags prevent the complete adjustment of each total of the risk assets from occurring in the months, or periods of months, concerned; it may be also that if due allowance were made for the actual sums involved in each case the final result would be materially different. To make allowance for the first possibility, however, would involve an arbitrary selection of months and decisions as to when adjustments could be presumed to be complete, both of which would seriously detract from the value of an analysis which seeks to let the figures speak for themselves. To allow for the second would involve such a complication of the analysis as to threaten its intelligibility. In any case, the total number of cases which have been analysed—816 in all —is large enough to justify the conclusion that errors arising from these causes would largely cancel themselves out. There is no reason for believing, in other words, that the distortions arising from insufficient allowance for a period of adjustment, or from failing to weight each case according to the sum of money involved, will be greater in any given direction in the 410 cases where liquidity was rising than in the 406 where liquidity was falling. Nevertheless, the somewhat crude nature of the analysis prevents any claim being made for the results other than that they seriously question the degree to which the clearing banks were influenced in the period 1925-39 by the kind of consideration suggested by the proponents of this version of the liquidity-ratio theory. That theory may not be unequivocally proved erroneous; but it is clear that it has to explain the statistics rather than rely upon them for support.

## Conclusion

What lessons can be learnt from this long and rather arid analysis of the liquidity practices of the British clearing banks during the years 1925–39? Firstly, a 30 per cent ratio simply did not exist in pre-war banking practice, nor is there evidence of it having been an effective minimum. Secondly, while the banks consistently kept a substantial proportion of their assets in liquid form, the proportion which such assets bore to total deposits varied widely between the banks and equally widely within any given year for each particular bank. Thirdly, there is in general no evidence to support the argument that a feature of pre-war banking experience was a contraction of deposits caused by a fall in liquid assets below some critical point. There are some examples of this happening, but almost all of them occurred within a period in which it would have been the height of triteness to comment that financial institutions were seeking liquidity. Apart from this, there is virtually no evidence of a secondary contraction following a fall in liquid assets below some crucial point. Perhaps there is some level of liquid assets at which such contraction would occur; but this can be no more than surmise. Finally, while it is not possible to flatly deny the assertion that the banks are less willing to expand risk assets when their liquidity is falling than when it is rising, a bare examination of the statistics tends to suggest the opposite. The proponents of this version of the liquidity-ratio theory are firmly and unquestionably left with the *onus probandi.*

These conclusions obviously modify the reliance which could be placed upon the secondary liquidity ratio as an instrument of credit control. A reduction of the banks' liquid assets may indeed eventually produce a contraction of credit, but the process would be so uncertain, both as to its extent and its timing, as to be of very dubious usefulness so far as monetary technique is concerned. The fact that the liquidity ratio is of significance especially in periods of acute depression and uncertainty is singularly unhelpful—during such a period it would be expansion rather than contraction which the authorities would be seeking, and it is unlikely that the banks would expand credit simply because their liquidity had increased. It may be that a tradition of 30 per cent, or some such ratio, will be built up from November 1951—certainly, energetic attempts are being made to this end. But if it is, it will be a new tradition, and not one which could claim its origin in the experience of the inter-war years. The fact that the new monetary policy is being operated through several channels other than the reduction of liquid assets renders unlikely any unambiguous evidence from our present experience; who is to apportion praise (or blame) in the contraction of bank advances between Bank Rate, Funding Loan and Mr. Butler's budget speech ? It may well be that the advantages of having a predetermined ratio of liquid assets through which to exercise credit control are great enough to justify a convention of such a ratio. But those who think so will have to get busy starting one.

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# CONCLUDING COMMENT

### By Harry G. Johnson

As Mr. Worswick remarked in concluding the first section of this Symposium, the contributors have raised a wide variety of issues on a number of levels; the second round has added to the diversity, although, with the exception of Professor Kahn's contribution, the emphasis has shifted away from the British economic crisis and towards the more technical aspects of credit control. In concluding the Symposium, I shall abide by my original role in it and at the same time follow the trend of the second round, by refraining from discussion of the balance-of-payments problem[1] in order to concentrate on more narrowly monetary matters, I shall not, however, attempt a systematic survey of all the issues which have been raised in this field, but will instead comment on various criticisms and misunderstandings of my original argument, and conclude with some more general reflections on the subject of credit control.

## I

Of the contributors of the Symposium, Professors Paish and Morgan and Messrs. Roosa and Frost have been most closely concerned with the arguments of my paper on credit control; for convenience and conciseness, I shall deal with the points they have raised more or less as they occur in the original paper.

Professor Morgan and Mr. Roosa have questioned my treatment of the problem of credit control last autumn as one of controlling bank advances, rather than the total of bank credit. As I explained in the paper, I chose this approach because it seemed to me to fit the conceptions of the monetary authorities more closely than the other; I did not intend to imply any necessary identification of credit control with the control of bank advances. There was, I think, empirical justification for concentrating on the restriction of bank advances last November: of the preceding expansion in the quantity of credit, by far the larger part was accounted for by the growth of advances[1]; the banks, for a variety of reasons[2] which have been discussed (in a different context) by Professor Morgan, were reluctant to expand their investments, but quite prepared to expand their advances; and there was some evidence (including the expansion of advances itself) that prospective borrowers were less well supplied than formerly with liquid assets which could serve as alternative means of finance to advances. Be that as it may, I based my argument on the assumption that the authorities, whether justified or not, were placing the emphasis on the restriction of bank advances—an assumption for which there is ample support in the *Economic Survey*.[3] But I did indicate that controlling the volume of advances was not the same thing as restricting the volume of bank credit; and I suggested that some contributor might wish to question the emphasis of official policy. The arguments I had in mind were those which have been ably expounded by Professor Morgan and Mr. Roosa; but I do not think that my argument supports their view that I have identified the control of advances with the control of bank credit. In particular, I can only attribute Mr. Roosa's charge that I and some others have set up ' a straw man—that only bank advances, and not the volume of bank credit, are (or should be ?) the object of concern ' to a rather careless reading of the arguments.[4]

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[1] I should perhaps record that the recovery of foreign confidence and inflow of capital on which so much emphasis was placed by some first-round contributors have proved rather disappointing. The inflow of capital largely took the form of a closing of short positions in trade credits, partly the result of revived confidence that the pound would not be devalued and of higher interest rates, partly the result of direct restrictions on overseas credits extended by London banks and acceptance houses—limitation of credits to ninety days in place of the previously typical four or more months, prohibition of refinancing and prefinancing credits, and confinement of new credits to goods actually in movement—which were introduced at the time of the Budget and should have been mentioned in my original article. Since then confidence has been sapped by the continuance of the balance-of-payments problem, rumours that the pound would be ' freed ', and doubts as to the Government's determination, while the effects of the direct restrictions have worked themselves out ; the exchange rate has accordingly sagged towards its lower (pegged) limit. More recently, the emphasis of Government economic policy has shifted from the heavy reliance on Bank rate presaged by the Budget Speech back towards direct and fiscal measures, notably in the further stretching of the rearmament programme.

The Board of Trade's restrictions on the terms of hire-purchase contracts were in May supplemented by a directive to the banks to reduce finance for hire-purchase by ten per cent by the end of September.

In any event, the emphasis of Professor Morgan and Mr. Roosa on the quantity of credit as the important variable affects only that part of my argument which was concerned with the possibility that the authorities, in place of orthodox measures, might have relied on an intensification of control through directives. If the attempt had been made last autumn to restrict the volume of bank advances by tighter directives while still maintaining the Treasury bill peg, the effectiveness of the policy in reducing inflationary pressure would of course have depended (as well as on the effectiveness of the controls) on the extent to which bank credit created by the purchase of investments replaced the advances which the controls frustrated. This in turn would have depended on two factors : first, the speed and efficiency of the osmotic process discussed by Professors Paish and Morgan, which as Professor Kahn has argued is a question of the perfection of the capital market on which we need much more information; second, the extent to which the institutional holders of Treasury bills (banks, discount houses, and holders of sterling balances) were prepared to increase their longer-term security holdings. While the osmotic process as Professor Paish describes it is undoubtedly a reality, I cannot follow the implications of Professor Morgan's argument to the point of believing that every applicant for an advance possesses an alternative (subtle and devious) way of raising the money by selling somebody's securities to the banks. Nor, for reasons which I have mentioned, do I think that the continued pegging of the Treasury bill rate would by itself induce the banks to satisfy a substantial demand for finance coming to them in this way. Consequently, I am not (in this particular case) prepared to accept the implication of Professor Morgan and Mr. Roosa's arguments that control over advances is futile without control over the total volume of credit.

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[1] Between October 1950 and October 1951, the Advances of the London Clearing Banks grew by £300 millions, whereas Investments increased by £50 millions; from October 1947 to October 1950 Advances had increased by £420 millions, Investments by only £5 millions. The contrast is, however, somewhat exaggerated by the writing down of investment values over the period.

[2] Notably that their investment portfolios, as Professor Morgan shows, were already uncomfortably long; their inner reserves were depleted by the writing down of investments which had gone on since 1947; and, with the authorities not supporting the gilt-edged market, their risk of possible capital loss from further increases in interest-rates was already very heavy.

In this connection I should like to revise, with apologies and with thanks to Professor Morgan, the argument of footnote 2 page 121 of my paper; the ' puzzle ' was not, as there stated, the reluctance of the banks to exchange bills for investments—Professor Morgan provides the explanation for that—but why they were willing to exchange them for Funding Stock when the latter was offered. The attractive maturities of the Funding Stock are a partial explanation; but it now seems generally accepted that official pressure was also applied.

[3] ' This continued growth of advances was the opposite of what was required in the face of the growing external deficit . . . Restraint was placed upon the quantity of advances, since in the main they could only be increased if a corresponding reduction was made in some other asset—for example, by the realisation of investments. . .. These changes (the reactions on the gilt-edged and new issues markets) reinforced the effect of the increased difficulty of obtaining bank advances.' *Economic Survey for* 1952 (London, H.M.S.O., Cmd. 8509), pp. 43–44.

[4] Compare, for example, Professor Kahn's arguments on pp. 150–151 of the first round of the Symposium. At some other points, too, it seems to me, the relevance of Mr. Roosa's argument might have been improved by more careful reading. For one thing, he seems to assume that before November last year the British monetary authorities were pegging the prices of bonds, rather than Treasury bills, which are a security much more specialized to the money market. For another, he does not seem to realize the extent to which qualitative credit controls have been, and continue to be, a feature of British techniques of credit control. These points recur below.

My analysis of the significance of the Treasury bill funding is the second point which has called forth comment from the contributors. Professor Robertson, and following him Professor Morgan, seem to me to err in describing the Funding as a ' once-for-all cleaning-up operation ', since by the time this appears in print the first £450 million will have become the equivalent of three-months bills, and the Treasury will soon have to decide whether to re-fund it or not. My view, which they criticize, that the Funding introduced a new technique of control was derived, not from the fact that it reduced the liquidity ratio, but from the fact that the authorities subsequently managed the floating debt in such a way as to keep the liquidity ratio tight—until this objective was was sacrificed in support of the end-April British Electricity Authority issue[1]—and from my opinion that tight liquidity exercised a restrictive effect independently of the discount rate. While I did not mean to imply, contrary to the assumption of Professor Morgan, that the authorities were exercising day-to-day credit control by manipulation of the supply of Treasury bills to the market, it seems to me that such day-to-day control could easily be achieved by variation of departmental holdings of bills.

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[1] Mr. Frost might have strengthened the argument of his first page with the fact that the reduction of advances between April and May was largely attributable to repayments from the proceeds of this issue.

The effectiveness of the control achieved by the Funding depended on the firmness of the thirty per cent liquidity ratio, which has been questioned by Professor Morgan. I must say that I am in strong sympathy with Professor Morgan's argument on this point, as I hinted in my original argument (p. 123): I can find little historical evidence for the ' tradition ' of the thirty per cent minimum,[1] and I agree that a rational banker should ' pay attention to the whole range of assets, and not merely to their division among a few rather arbitrary categories.' However, bank chairmen, financial journalists, and even the *Economic Survey*[2] have affirmed the importance of the thirty per cent conventional minimum, and the banks seem to have been acting on it so far; so that Professor Morgan's arguments should, I think, be taken as underlining the arbitrariness of the convention and warning against too great or prolonged official reliance on it.

Mr. Frost accepts the historical validity of the thirty per cent tradition, but maintains that ' it does not become effective until the proportion of liquid assets has been squeezed below 30 per cent,' so that the reduction of bank liquidity has so far had a negligible effect in restricting bank advances. This version of the liquidity ratio convention I find inacceptable : if the banks *do* regard thirty per cent as a minimum liquidity ratio, it seems to me that a reduction of their liquid assets will cause them to take action before rather than after the ratio has reached thirty per cent—though they may at times be unsuccessful in preventing a fall below the thirty per cent level. For this and other reasons I do not share Mr. Frost's view that ' the mechanical effect of the purely monetary measures on bank lending has been negligible '; but this conclusion that ' the most effective measures have been the direct controls ' must, I think, be accorded some weight.[3]

In the course of discussing the desirability of orthodox measures, I mentioned reasons for thinking that the results might not correspond to the requirements of the national interest, and stated that the Government's intensification of qualitative controls was an admission of this possibility. I did *not*, as Professor Paish seems to think (p. 144), argue that ' tight money reduces the banks ' willingness to comply with Government priorities '—for at that point I was discussing pure orthodoxy, not the present combination of orthodox measures with qualitative controls. I am quite in agreement with Professor Paish's point that, *given* a set of priorities, financial stringency may make the banks more willing to apply the priorities strictly. But I would point out that to advocate orthodox measures as a means of reinforcing selective controls is not the same thing as recommending orthodoxy for its own sake, and that if credit restriction does induce the banks to rely heavily on priorities, some of the other advantages claimed for orthodoxy—for example its generalization of restrictive pressure—may lose some of their force.

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[1] The matter, however, requires more investigation than Professor Morgan gives it ; the real test is not whether the banks maintain a constant liquidity ratio, but whether a reduction of the ratio towards thirty per cent. is associated with a contraction of other earning assets than the conventionally ' liquid ' ones. Moreover, except on the untenable argument that the individual banks base their policy on the Clearing House aggregate figures, an investigation of the ratios of individual banks is required. My own scepticism is based on a pioneer study by Dr. E. T. Nevin which has been carried out on these lines, and which is printed in this BULLETIN, pp. 285–297.

[2] ' The operation had the effect of reducing the liquid assets of the banks to little more than the conventional minimum of 30 per cent of total deposits ' (*op. cit.*, p. 43). ' Lombard,' of *The Financial Times*, has even explicitly contradicted, with the concurrence of the banks, Professor Morgan's (and my own) view that ' a very short bond is as liquid as a bill,' in the course of an argument denying that as the Funding Stock matured the pressure on bank liquidity would be relaxed. Cf. *The Financial Times*, May 1st (*Letters to The Editor*), May 10th (*Banking and Finance*) and May 21st (*Letters*). In the issue for May 10th, ' Lombard ' asserted that the banks ' never have counted a " bond " of any sort as a liquid asset, as they do Treasury or commercial bills.'

[3] I should like to record my gratitude for his discussion of changes in the terms of long-term borrowing, which I think fills a gap in the first round of the Symposium. Many of his other points I have also found interesting ; but I think that his argument that ' assuming that liquidity ratios had been cut to the bone . . . pressure upon them can only be maintained by the use of bank rate ' rests on a misunderstanding.

Professor Morgan and Mr. Roosa have gone further than Professor Paish, and have affirmed their preference for rationing by bankers as an alternative to direct controls. To this question I shall return; but it does seem to me that they have over-stated the degree of decentralization of decisions in contemporary British banking administration, and under-estimated the power and flexibility of present methods of qualitative credit control.[1]

This brings me to the two alternative methods which, I suggested, could have been employed in place of those adopted last autumn by the monetary authorities. My purpose in suggesting them was to provoke a rational discussion of the technical problems and possibilities of British monetary policy, as a corrective to the *mystique* of Bank rate and ' orthodoxy ' which revived so rapidly after November. In this I think I have been successful, thanks to the co-operation of the contributors. It was perhaps inevitable that my ' could ' has been translated into ' should ', my suggestions have become ' policy recommendations ', and I have become something of an Aunt Sally for anti-planners; I should at any rate like to express my gratitude to Professor Hicks for his generous interpretation of my intentions.

With reference to my suggestion of a required liquid reserve ratio, it would probably have clarified the argument and saved confusion if I had avoided the analogy with the American Secondary Reserve Plan and instead acknowledged the source of the suggestion in an earlier article of Professor Paish's.[2]

The analogy with the Secondary Reserve Plan seems to have been a source of confusion, particularly to those familiar with the history of the Plan, since the Plan was recommended as a solution to problems which it could not solve; specifically, while it could help to hold down the rates on securities included in the requirement, it could not serve as a means of control over the volume of credit so long as the Federal Reserve was supporting the prices of any securities held in substantial volume outside the required reserves by holders prepared to sell them if a better yield offered elsewhere. However, the situation in England up to 1951 was not the same as it was in the United States (although Mr. Roosa seems to write as if it were); the authorities were pegging the price of only one security, the Treasury bill, specialized to a small group of holders; and under these conditions a secondary reserve agreement, or requirement, could have been designed which would have served the dual purpose of controlling the volume of credit while holding down the interest-cost of the floating debt. There may, as Professor Paish has suggested, be other reasons for rejecting such a scheme; but I do not think that it can be dismissed on the grounds that it would not work.

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[1] I should like to assure Mr. Roosa that one can have several years of experience with the shortcomings of controls without necessarily coming to the conclusion that ' price-system methods ' are invariably superior. I also do not see why the fact that controls have to be intensified when the problems they have to meet become more serious should, by itself, make them less desirable than monetary policy—which is subject to the same objection.

[2] ' Prospects for Interest Rates,' *London and Cambridge Economic Service*, BULLETIN I, Vol. XXVIII (February 1950) pp. 13–15. Professor Paish's suggestion was far more tentative than mine, and was aimed at assisting a rise in long-term interest rates ; but it included the suggestion that the rate on marginal supplies of Treasury bills might be allowed to vary.

In connection with the liquidity reserve suggestion, I made the subsidiary suggestion that the willingness of borrowers to borrow might be influenced by means of taxes. This suggestion emanated (at several removes) from Professor Hicks, and I am glad that he has taken the opportunity offered by the second round of the Symposium to expound the scheme in detail in his own lucid way. As he presents it, it becomes a full-fledged alternative instead of a subsidiary measure, with many advantages to recommend it. The only technical flaw I see is that it does not seem to provide for control over lending by the Complex to outsiders *via* security purchases; this could probably be remedied by having the tax apply also to increases in the Complex's investments.

The other alternative I suggested was more extended use of direct controls. It is perhaps worth repeating that such controls are provided for in the Bank of England Act; they have been employed since the beginning of the war, and are by now almost a traditional feature of British monetary control; and the monetary authorities have in fact intensified their use of them since the inception of the new monetary policy. To suggest that the authorities might have relied on these powers without unpegging the Treasury bill rate is therefore to suggest a more determined use of existing powers, and not, as Mr. Roosa puts it, 'developing a new panoply of direct controls for the commercial banking sector of the economy'.

My own view is that much more could have been accomplished in the way of credit restriction by the stricter application of existing methods of control over advances; and, for reasons I have stated earlier, I do not think that under the circumstances the controls would have been rendered ineffective by substantial bank purchases of securities. Any marked tendency in that direction could have been met by directives to the banks. Stricter control over advances might, as Professor Paish remarks, have required the setting of individual ceilings on bank advances (or possibly on total assets); I do not see any strong objection to such ceilings, applied for a short period to a system consisting of a few large banks whose relative sizes have been comparatively stable over a number of years. Such ceilings on advances have recently been applied in Canada, which has a rather similar banking system.

## II

Practically the only agreement on basic principles to emerge from the Symposium seems to be a general acceptance of the effectiveness of orthodox monetary weapons (*i.e.* Bank rate and open market operations, but not qualitative credit controls) as a means of restricting aggregate effective demand. In particular, I think, most of the contributors would agree that a fairly small degree of credit restriction, as measured by its effects on interest rates, can have a quite substantial restrictive effect on economic activity. The factors of uncertainty and expectations, which at one time were held to limit severely the influence of changes in interest rates on investment, have turned out on closer inspection to be themselves variables which monetary policy can mobilize to serve its own ends; it has also been recognized that the terms on which credit is made available fluctuate more widely, and may be much more significant, than its price. Consequently monetary policy is once more regarded as a potent restrictive instrument, though far less because of its influence on the interest-cost of borrowing than for its effects in generating uncertainty and the expectation of lower future interest rates among borrowers and lenders, and so leading the former to abandon or postpone plans for borrowing and the latter to tighten the terms of lending.

Another factor which may add force to the influence of a small (policy-motivated) change in rates is the implied threat that the monetary authorities are prepared to go as much further as is necessary to achieve the results they want.[1] Under contemporary conditions this threat is almost bound to seem a bluff (even if it is not) owing to the inhibitory presence of a large unfunded public debt and, probably more important, of full employment and other policy commitments of the Government.[2]

But while there is agreement on the *effectiveness* of monetary policy, there is fundamental disagreement over its *efficiency* as an instrument of economic policy. Critics of the monetary weapon stress that the effects of any given degree of credit restriction are unpredictable as to magnitude, timing, and distribution—the latter because the rationing effects of changes in uncertainty and the terms of credit, on which the effectiveness of the weapon largely depends, are arbitrary in their incidence—and that therefore monetary policy is difficult to handle and wasteful in its effects; they distrust it, and tend to prefer direct controls. Advocates of monetary policy discount these criticisms, and stress the flexibility of monetary policy as contrasted with the rigidity, varying effectiveness, and tendency to leakages of controls.

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[1] In this respect there may be significant differences between Bank rate and open market operations, and so between British and American monetary policy.

[2] Cf. Professor Hicks's two contributions. The problem is perhaps even more serious in connection with the second sphere of influence of monetary policy—the attraction of short-term international capital movements—where success now depends very much on the inspiration of confidence.

Set up in such general terms, the argument can only lead to an affirmation of personal preferences as between the imperfections of monetary restraint and the imperfections of controls. This solution, while in the best tradition of modern welfare economics, seems to me an unsatisfactory one for two reasons. In the first place, it tends to foster an unhelpful confusion of means and ends, with some economists recommending monetary policy because they would prefer a free enterprise economy, and others recommending controls because they would prefer a different system—regardless of the situation facing the economic policy-makers, or of the extent to which the community shares their preferences for one or another social system. In the second place, it tends to promote the false impression that monetary policy and controls, as policy instruments, are strictly substitutes for one another.

A more useful approach, I think, is to regard monetary policy and direct controls as both substitutes and complements.[1] Monetary restriction can bring pressure to bear on aggregate demand perhaps more pervasively and effectively than a (practicable) system of controls; controls can at least attempt to discriminate efficiently between different lines of activity, which monetary policy cannot. The two together may well produce more satisfactory results for economic policy, than either alone.

The proper combination cannot be decided on *a priori*; it depends on the one hand on the institutional, political, and social environment and on the other on the degree of specificity which is aimed at in economic policy—more accurately, on the extent to which economic policy aims at a pattern of results unobtainable quickly or closely enough through the price system even as modified by fiscal measures.

In the British economy, with its chronic balance of payments difficulties and its no less exacting full employment and welfare state commitments, the content of economic policy must, I think, inevitably be highly specific. This implies that monetary policy should be used as a supplement to budgetary and direct measures of control. As such, it can play a useful subordinate part in reinforcing and lightening more discriminatory methods of control—although, as I have argued, it could be more carefully designed for its purposes. But there are two dangers which must be guarded against : the first is that the use of monetary measures may distract attention from the need to tackle specific problems with specific measures—monetary policy may be over-loaded with specific objectives which it cannot achieve, to its longer-run disrepute as a policy instrument. The second danger is that, unless monetary measures are carefully applied, their psychological and economic repercussions may seriously interfere with, rather than assist, the specific measures. In brief, I think that great care should be taken to keep monetary policy to its complementary role ; in this connection it would be helpful if the authorities invoked the *mystique* of Bank rate less, and provided a more detailed explanation of what monetary measures are expected to achieve.

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[1] In the full context of economic policy, fiscal policy is also both substitutary and complementary to monetary policy and controls.

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